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THE POST-CRISIS CAPITAL ADEQUACY FRAMEWORK FOR EUROPEAN BANKS: A POLICY TRADE-OFF BETWEEN FINANCIAL STABILITY AND BANKS' PROFITABILITY?

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[…] And so each venture
Is a new beginning, a raid on the inarticulate
With shabby equipment always deteriorating
In the general mess of imprecision of feeling,
Undisciplined squads of emotion. and what there is to conquer
By strength and submission, has already been discovered
Once or twice, or several times, by men whom one cannot hope
To emulate – but there is no competition –
There is only the fight to recover what has been lost
And found and lost again and again: and now, under conditions
That seem unpropitious. but perhaps neither gain nor loss.
For us, there is only the trying. The rest is not our business.

T.S. Eliot, Four Quartets, East Coker (Vol. II), 1940

[…] E così ogni impresa
E' un cominciar di nuovo, un'incursione nel vago
Con logori strumenti che peggiorano sempre
Nella gran confusione dei sentimenti imprecisi,
Squadre indisciplinate di emozioni. E quello che c'è da conquistare
Con la forza e la sottomissione, è già stato scoperto
Una volta o due, o parecchie volte, da uomini che non si può sperare
Di emulare – ma non c'è competizione –
C'è solo la lotta per recuperare ciò che si è perduto
E trovato e riperduto senza fine: e adesso le circostanze
Non sembrano favorevoli. Ma forse non c'è da guadagnare nè da perdere.
Per noi non c'è che tentare. Il resto non ci riguarda.

T.S. Eliot, Quattro Quartetti, East Coker (Vol. II), 1940

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INTRODUCTION

Credit institutions occupy a unique position in economic systems. In national settings, banks are particularly influential actors in the context of monetary policy, payment systems administration and credit allocation. These roles ensure that banks are essential in maintaining the integrity and function of financial and social systems. In the wake of the recent global financial crisis, the international, cross-border connections between banks and their vulnerabilities to systemic shocks were starkly highlighted by the rapid contagion that spread from the US interbank market and financial sector to European economies in 2008. The vulnerability of national economies to the downturn in the banking sector and the precipitous cost of bank bailouts to both governments and taxpayers that followed the crisis served to further emphasise the intricate – and often opaque – links between banking intermediaries, their stakeholders and the broader economy. At the same time, the financial crisis starkly revealed the severe risks that lie behind the degree of interconnectedness that capital markets and cross-border banking services have reached, at the global level, in the last forty years – something that has been defined in the literature as 'financial globalisation'. One figure may immediately give substance to this statement. According to the Bank for International Settlements, as at October 2020, outstanding cross-border banking claims at the global level approximately amount to half the size of the entire world's gross domestic product, that is an overall value of around USD 40 trillion.

While integrated economies can benefit from better matching of saving and investment, from greater choice and from risk sharing and diversification, financial globalisation also implies that economic actors import and export financial risk from across borders. Without appropriate governance systems and regulation at the supranational level, the disastrous economic effects of a systemic banking crisis may become uncontrollable virtually for any sovereign nation. Indeed, the costs of the global financial crisis of 2007-09 were profound and are still raw. Estimates from the International Monetary Fund suggest that current output levels remain below pre-crisis trends in more than 60% of the world's economies. The outbreak of the Covid-19 pandemic has further deteriorated already fragile economic environments and market expectations, causing the most widespread fall in per capita income in mature economies since 1870. At this point in time, it is difficult to estimate how many years it will take to approach the pre-financial crisis output levels.

In the wake of the global financial crisis, and faced with the need for immediate mitigation and deeper regulatory reform, international standard-setters, under the aegis of the G-20 and the International Monetary Fund, as well as EU policy-makers at the regional level, were swift to respond. Since the crisis first hit European shores and triggered the sovereign debt crisis, EU financial regulation has significantly evolved in terms of supervisory infrastructure and substantive reach. Indeed, prior to the crisis, financial regulatory developments focused predominantly on market integration and efficiency considerations. Although the sound and prudent management of credit institutions, investors' protection and overall financial stability were important policy objectives and apparent in existing regulatory instruments, there was arguably a lack of focus on prudential concerns. In the aftermath, European authorities realised that excessive risk-taking behaviours in the run-up to the crisis were supported by the belief of many bankers that their institutions were too big to be allowed to fail, also as a consequence of the deferential and accommodating, insufficiently challenging, supervisory approach that national public authorities had vis-à-vis the domestic banks they had to supervise. As a result, global and EU regulatory reforms have been driven heavily by risk assessment considerations and a strong focus on micro- and macroprudential concerns emerged.

At the European level, the reform process to denationalise banking supervision and resolution arrangements to ensure a level playing field among European lenders, as well as their capital soundness, brought to the establishment of the Banking Union, that is the most far-reaching reform of institutional harmonisation and administrative centralisation within the Euro area since the creation of the euro. This was rendered necessary also to avoid the banks' bailouts that critically characterised the action of European governments from occurring again. Between 2008 and 2014, the European Commission authorised extraordinary state aid measures to recapitalise EU banks in the amount of EUR 3.89 trillion, corresponding to around 30% of the entire European Union's gross domestic product in 2013. Under this perspective, the Banking Union project launched in June 2012 by EU authorities can be considered a reform comparable in importance to the customs union (1957), the competition framework (from the 1960s onwards), the single market (1990s), or, indeed, the more recent launch of the euro (1999). In particular, the European Banking Union has been established as a regulatory framework, or European financial safety net, built upon three pillars, which centralise to the European level administrative functions carried out, until the establishment of the Banking Union, by Euro area national authorities. The first pillar establishes a single mechanism for the supervision of banks, the second pillar lays down a Eurozone-wide integrated crisis management regime, and a third pillar – in contrast to the other two pillars, at present not operational yet – would provide for a common system for deposit guarantees.

For Eurozone credit institutions, this 'Copernican revolution' in the institutional environment, coupled with the approval of the Basel III Accord by the Basel Committee on Banking Supervision, has implied a radical change in the way of conducting the business of banking. Following unprecedented economic and financial deterioration, the approval of Basel III represented utterly needed regulatory effort to restore public confidence in banking systems and supervisory action. However, while undoubtedly necessary, the implementation of the Basel III reform came at a significant price. Within the European Union, the co-legislators implemented the new prudential requirements by means of two separate legislative streams over a time period of six years (2013 - 2019). Aiming at safeguarding the public good of financial stability, revisited EU prudential rules required European banks to hold significantly higher capital reserves and brought about higher compliance costs on, among others, liquidity risk management arrangements, reporting mechanisms and loss-absorbing resolution regimes.

From a macroeconomic perspective, banking intermediaries play a pivotal role in financing firms and households, and thus help to promote economic growth and prosperity at the aggregate level. In other words, banking systems are a medium by which saving of households and corporates can be channelised into productive investment, which will boost national income, namely aggregate consumption demand and aggregate investment demand, in multiplier effect. If commercial banks are not profitable, i.e. they do not earn net interest margins, credit creation is limited, and, as a consequence, gross domestic product is more likely to remain stagnant. Needless to say, in an already very convoluted regulatory and economic transitional phase, the pandemic triggered by Covid-19 has further challenged the lending functions of European banks.

Against this backdrop, numerous studies in legal and economic scholarship highlighted how compliance with the European version of Basel III, and particularly capital rules, required banks to sustain tremendous costs – in the range of trillions of euro – for recapitalisation and risk management improvements. To achieve regulatory compliance, a significant number of banks preferred to re-size their balance sheets, deleverage on risk-weighted assets and rebalance their portfolios. Over time, this structural transformation has had an impact on the profitability drivers of the banking sector and the broader economy, resulting in what a growing body of quantitative studies defines as a decline in credit availability for large corporates, small and medium enterprises and households, and, possibly, a decline in gross domestic product growth. Indeed, while there is strong empirical evidence suggesting that the net macroeconomic benefits of capital requirements are positive over a wide range of capital levels, as the benefits of the Basel capital regime accrue both to society as a whole, in the form of reduced frequency and impact of banking crises, and to banks directly, in the form of lower funding costs and better-quality lending, growing consensus has undoubtedly emerged among academics that part of these new international capital regulations may likely have adverse economic effects, especially for lower-risk institutions. This may even contradict the ultimate objective of policy-makers and prudential standards to strengthen the financial stability of the system.

Under this perspective, numerous empirical papers clearly indicate that, while an increase in capital requirements has a positive impact on the real economy in the long term, reductions of the loan supply and deleveraging of risk-weighted assets are most likely to occur in the short term. At the European level, stakeholders and think tanks have warned policy-makers that banks would have likely met the increased EU capital adequacy requirements either by widening spreads between lending and deposit rates in order to boost net income, or by reducing exposures and loans. Concrete evidence of such a pattern have been the tremendous difficulties encountered by European banks, during the last ten years, to generate return on equity and remain profitable with business models characterised by compressed margins – something that the Chair of the Single Supervisory Mechanism has recently, and worryingly, defined as the ‘profitability malady’ of the Euro area banking sector. Moreover, further idiosyncratic factors negatively affecting the profitability drivers of European banks, namely negative interest rates, the Fintech revolution and stark competition in overbanked markets, do not support European intermediaries in the assimilation of the new capital regulations while, at the same time, offering return on equity to investors. In a nutshell, it appears clearer and clearer that the costs and benefits of the new banking capital regulations should have been more carefully weighted by European supervisors and regulators.

The aforementioned prudential concerns introduce the reader to the ultimate objective of this work, that is to carry out an assessment of the European post-crisis capital adequacy framework applicable to Eurozone credit institutions under the first and second pillar of the Banking Union, i.e. the Single Supervisory Mechanism and the Single Resolution Mechanism, with a view to evaluating, in light of the ascertained costs to raise equity and debt capital, whether the fundamental rights of European banks before administrative authorities as to the imposition of capital requirements are fully upheld. Indeed, in addition to the challenges posed by increased minimum capital requirements and the recently introduced binding 3% non-risk-based leverage ratio, Eurozone banks have now to interface themselves with rigorous and supranational administrative supervisory and resolution authorities, i.e. the European Central bank and the Single Resolution Board, which have been entrusted with a broad prudential and sanctioning toolkit, together with intrusive authorisation powers relating to the computation of financial instruments in regulatory capital ratios and the use of internal models to calculate minimum capital levels.

In terms of structure, this doctoral work aims at connecting several strands of the literature. The literature on banking capital requirements is the obvious starting point. In this sense, Chapter One will analyse the prudential standards embedded in the soft-law international framework developed by the Basel Committee on Banking Supervision and their application to large, internationally active banks. The content of this Chapter will deal, in particular, with the prudential requirements relating to the quality and composition of the banks' capital base and the function that banking capital has recently assumed as to safeguarding financial stability and ensuring market discipline vis-à-vis investors, markets and depositors. The aim of the Chapter is to shed light on how the Basel Committee on Banking Supervision's supervisory framework flexibly evolved over the decades in response to different global sovereign or financial crises, with the primary goal to ensuring international financial stability and the soundness of financial institutions. Accordingly, a dedicated Paragraph will discuss how virtually all countries over the world – and not only the Committee's member jurisdictions – tend to implement the Basel framework as golden benchmark in banking supervisory and prudential matters, and what currently are the main challenges and trade-offs that developed jurisdictions as well as emerging and low-income economies face in the implementation of international capital banking standards.

Chapter Two will turn the focus of this work to the European Union. In particular, Chapter Two will discuss the establishment, in line with the international benchmark developed by the International Monetary Fund, of the Single Supervisory Mechanism, as first pillar of the Banking Union and European transnational banking supervisory net composed by national and supranational authorities. Accordingly, Chapter Two will illustrate the key reasons why the Single Supervisory Mechanism constitutes a 'Copernican revolution' in European administrative and banking law, and the way in which it created a complex, multi-layered pan-European system of prudential supervision that significantly reshaped the operation of public supervisory administrations within the Eurozone – and the non-Eurozone Member States participating to the Single Supervisory Mechanism (currently two, i.e. Bulgaria and Croatia). Under this perspective, Chapter Two will discuss in detail the macro- and microprudential supervisory tasks and powers that have been centralised to the European Central Bank to ensure compliance by Euro area credit institutions with the Basel capital standards (and the implementing European legislation). To this end, Chapter Two will discuss the European Central Bank's supervisory decision-making structures deputed to adopt regulatory acts and administrative individual supervisory decisions addressed to significant credit institutions as well as, where applicable, less significant credit institutions.

In line with the arguments developed in Chapter Two, Chapter Three will focus, specifically, on a sub-set of prudential tasks and powers entrusted to Banking Union authorities, namely prudential tasks and powers over the capital of Eurozone credit institutions. In this context, Chapter Three will analyse, among others, under what conditions significant Eurozone banks may receive permissions from the European Central Bank, as prudential supervisor, to compute financial instruments as capital for regulatory purposes, to reduce their own funds and to use internal measurement approaches to calculate risk-weighted assets and minimum capital levels. Correspondingly, Chapter Three will also discuss the public administrative powers that have now been centralised to the Single Resolution Board in respect of the newly-introduced minimum buffer of liabilities eligible to be computed for resolution and recapitalisation purposes. Finally, Chapter Three will analyse the early intervention powers and sanctioning measures centralised to the European Central Bank in case of non-compliance by Eurozone banks with capital adequacy provisions.

Chapter Four concludes with a critical assessment of the Banking Union project and the newly established European capital adequacy framework. In doing so, the Author of this work relies also on quantitative academic literature assessing the costs and benefits of banking capital requirements. In particular, Chapter Four will illustrate how financial stability represents an outright objective of EU banking legislation and the main reasons for subdue profitability of Eurozone banks. On such a basis, Chapter Four will conclude with a critical analysis of the positive achievements and the unexpected drawbacks of the recently reformed European capital adequacy regime, as well as will discuss the expected impact of new Basel IV Accord on European banks. Finally, Chapter Four will put forward policy recommendations aiming at, on the one hand, removing regulatory obstacles in European banking legislation in order to support the creation of a banking sector truly pan-European and ease the ‘profitability malady’ of Euro area lenders, while, on the other, ensuring full judicial protection of European banks against certain micro- and macroprudential supervisory decisions adopted by the Single Supervisory Mechanism and imposing higher capital requirements, as mandated by the Charter of Fundamental Rights of the European Union and the Treaty on the Functioning of the European Union.

LIST OF ABBREVIATIONS – CHAPTER ONE

AIG	American International Group
AEG	Accounting Experts Group
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
AT1	Additional Tier 1
BCBS	Banking Committee on Banking Supervision
BCG	Basel Consultative Group
BIS	Bank for International Settlements
bp	basis point
CBGF	Central Bank Governance Forum
CDS	Credit Default Swaps
CGFS	Committee on the Global Financial System
CPMI	Committee on Payments and Market Infrastructures
CVA	Credit Valuation Adjustment
EM	Effective Maturity
EAD	Exposure at Default
ECB	European Central Bank
EBA	European Banking Authority
EBU	European Banking Union
EC	European Commission
EFSM	European Financial Stabilisation Mechanism
ESM	European Stability Mechanism
EU	European Union
FATF	Financial Action Task Force
FDIC	Federal Deposit Insurance Corporation
FED	Federal Reserve System
FRTB	Fundamental Review of the Trading Book
FSAP	Financial Sector Assessment Programme
FSB	Financial Stability Board
FSF	Financial Stability Forum
GEM	Global Economy Meeting
GDP	Gross Domestic Product
GFC	(2007-08) Global Financial Crisis
GHOS	Group of Governors and Heads of Supervision
G-SIB(s)	Global Systemically Important Bank(s)

G-SIFI(s)	Global Systemically Important Financial Institution(s)
HQLA	High-Quality Liquid Assets
IAASB	International Auditing and Assurance Standards Board
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICAAP	Internal Capital Adequacy Assessment Process
IFC	Irving Fisher Committee on Central Bank Statistics
IFRS Foundation	International Financial Reporting Standards Foundation
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IOSCO	International Organisation of Securities Commissions
IRB	Internal Ratings-Based
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
MPE	Multiple Point of Entry
MPG	Macroprudential Supervision Group
NCWL	No Creditor Worse Off than in Liquidation
NGO(s)	Non-Governmental Organizations
NSFR	Net Stable Funding Ratio
OECD	Organisation for Economic Cooperation and Development
OTC	Over-the-Counter
PD	Probability of Default
PDG	Policy Development Group
RCAP	Regulatory Consistency Assessment Programme
ROSC(s)	Report(s) on the Observance of Standards and Codes
RWAs	Risk Weighted Assets
SA	Standardised Approach
SCAV	Standing Committee on Assessment of Vulnerabilities
SCSI	Standing Committee on Standards Implementation
SRC	Standing Committee on Supervisory and Regulatory Cooperation
SEC	Securities and Exchange Commission
SIG	Supervision and Implementation Group
SIFI(s)	Systemically Important Financial Institution(s)
SME(s)	Small and Medium Enterprise(s)

SPE	Single Point of Entry
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TARP	Troubled Assets Relief Program
TLAC	Total Loss-Absorbing Capacity

CHAPTER ONE

THE LONG JOURNEY TOWARDS ENHANCED BANKING CAPITAL ADEQUACY

I. The Rise of Global Administrative Law and the Origins of the Basel Committee on Banking Supervision

In the last century, the acceleration of the process of globalisation has impacted upon legal institutions as much as the economy. Global regulatory regimes and international institutions or fora have been established at an extraordinary pace in almost all subject areas, due to empirical evidence that global problems require global solutions. Once compared to traditional administrative law, global regulatory regimes display several peculiarities: First, they are not hierarchical, as there is no single regulatory regime that has supremacy *vis-à-vis* the others, nor are they hierarchically superior to national governments. Second, they are sectorial, as global administrative law[1] develops in response to the emergence of a specific public issue that cannot be dealt with by the actions of single states. Third, in the context of global administrative law, national governments act as law-makers within international institutions or fora, but they are also the main addressees of substantive and procedural standards[2].

In the post-Bretton Woods era, and particularly following the outbreak of the global financial crisis in 2007-08, public international financial regulation, as a sub-category of global administrative law, has become a significant example of the pervasiveness of global regulatory regimes. Indeed, the vast majority of rules embodied in public international financial regulation, in the form of global financial standards, which are aimed at the achievement of key policy and regulatory objectives in the international financial system, are being adopted by international financial fora[3]. These fora do not have the capacity of an international organisation. They have not been established by virtue of an international treaty, do not have legal personality, usually do not have a Charter (or Articles of Association) nor are they administered by formal organs. Frequently they are set up *ad hoc* as a response of the international community[4] to major financial crises with transnational dimensions and,

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[1] For an introduction to global administrative law, see Craig (2015); Brummer (2015); Cassese et al. (2012). For the interactions between global administrative law and EU administrative law, see Chiti and Mattarella (2011).

[2] Cassese et al. (2012), p. XXV.

[3] In addition to the Basel Committee on Banking Supervision, comprehensively examined in Chapter 1 of this work, further examples of international financial fora are the International Organisation of Securities Commissions (**IOSCO**), responsible for prudential supervisory standards of investment firms; the International Association of Insurance Supervisors (**IAIS**), responsible for prudential supervisory standards of insurance and re-insurance undertakings; the Financial Stability Board (**FSB**), responsible to identify and assess risks and vulnerabilities in the international financial system and to set standards for the resolution of credit institutions; the Financial Action Task Force (**FATF**), responsible for standards combating money laundering and terrorist financing (**AML/CFT**). Some of these international fora form part of the so-called 'Basel Process' (on the latter, see Paragraph 1.1). Over the last 50 years, the number of international fora composing the global financial architecture and their role in shaping public international financial regulation has become increasingly significant. For an overview in the literature, see Gortsos (2019); Lastra (2015); Cassese et al. (2012).

[4] In the current global governance model, the G-20 is widely regarded as the guiding international forum for sealing international financial and political economy interests, being an international body eminently of political composition. Founded in 1999 as successor to the G-10 following the South-East Asian crisis, the G-20 includes as its members Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States and the European Union, which collectively accounts for about 85% of the global gross domestic product (**GDP**), over 75% of global trade and two-thirds of the world population. In this sense, the G-20 is the premier political forum for international economic cooperation and decision-making, having assumed a leading role in the current global governance model in which it sets the global regulatory

because of their main objective, are commonly referred to as 'standard-setting bodies' or 'standard setters'. In this context, 'standards' can be understood, in their simplest form, as a model rule that needs to be further specified due to its inherent incompleteness. The content specification of financial standards is usually made in the context of *ad hoc* implementation processes into regional or national legal regimes by legislative or administrative authorities[5]. In this sense, the current global governance model of financial regulatory production[6] can be described as having four levels, which incorporate a range of financial international organisations and fora that play different roles. At the first level, there is a transnational structure, or network, which has mainly been established through political processes as a response to the international consensus to address some key policy issues of the global monetary and financial system. The second level is the formulation of global standards, largely carried out by bodies or authorities of technocratic nature with relevant expertise and experience. At the third level is the implementation of standards, which is in principle a regional or domestic process but with technical assistance through a variety of international, regional and bilateral sources. The fourth level focuses on monitoring the implementation of standards. Importantly, however, under this system, the ultimate responsibility for implementation of policies to strengthen financial systems lies with the governments and public independent authorities of countries, as usually these international organizations and fora lack binding enforcement powers[7].

Public banking regulation and (macro- and micro-) prudential supervision are a representative case of this global governance model of finance[8]. The harmonisation of banking standards, at the international level, is carried out by the Basel Committee on Banking Supervision (**BCBS**), established in 1974 by an informal decision of the Governors of G10 members' central banks and Switzerland, as a reaction to the systemic impact caused by the failure of then West Germany's largest private bank *Bankhaus I.D. Herstatt*, and subsequent withdrawal of the banking licence by the West-German supervisor on 26 June 1974[9]. Such banking crisis, coupled with the concurrent bankruptcy

agenda and coordinates multiple transnational regulatory networks and international standard-setting bodies, in this way contributing significantly to shaping international financial regulation.

[5] Due to their widespread acceptance, global standards are a common point of reference amongst member jurisdictions, which means that a minimum level of international harmonisation is usually achieved on the regulation of a specific issue. It is noteworthy that many international organisations and fora do not name the standards they issue as such, but they use terms such as recommendations, core principles, best practices, guidelines, codes of conduct, or codes of best practice. In general terms, all these concepts should be considered as synonymous to the concept of standards. On the topic of international standard-setting institutions and fora, see Gortsos (2019), p. 49 ff.

[6] While the term 'governance' is closely related to the word 'government', the two terms have a different meaning. As a matter of fact, it is possible to have governance of global financial systems even though there is no global government. While the term 'governance' refers to legislation, regulation and the institutions of government, it also encompasses broader frameworks of standards, norms and conventions, international organisations and agreements that fall short of hard law. Indeed, in a world of nation states and national legislatures and governments, it is on these broader frameworks that national governments depend for the governance of financial globalisation and the management of cross-border risks. See Cunliffe (2020).

[7] Arner and Taylor (2009), p. 2.

[8] On the objectives of financial regulation under a cross-sectorial perspective, and the effects of financial regulation on the integration of EU financial markets, see Wymeersch (2019). On the relationship between regulatory complexity and systemic risk, see Gai et al. (2019).

[9] The liquidation of *Bankhaus I.D. Herstatt* was due to excessive exposure accumulated by the German credit institution to exchange-rate risk as a result of major open positions in forward foreign-exchange transactions. The impossibility by *Bankhaus I.D. Herstatt* to settle its open positions created unprecedented upheaval in the international interbank market as several banks in other countries (such as the British *Hill Samuel Group Ltd*, as well as *Morgan Guarantee Trust Company and Seattle First National Bank* in the United States) were severely exposed to the German counterparty. In August of the same year, BaFin had to take administrative measures and revoke the license of three other (smaller)

of the *American Franklin National Bank of New York* in the two-year period between 1973 and 1974, demonstrated the need to strengthen international cooperation in the field of banking supervision and regulation. Since its establishment, the BCBS (or 'Basel Committee on Bank Regulation and Supervisory Practices', as it was originally known) is seated at the Bank for International Settlements (**BIS**)[10] in Basel (Switzerland). The Committee does not possess any formal supranational authority or legal personality, and its decisions (such as the adoption of global prudential standards) have per se no legal force, belonging to the realm of soft law[11]. The BCBS adopted its Charter in January 2013[12], almost 40 years after its establishment, upon approval by the Group of Governors and Heads of Supervision (**GHOS**), which is the BCBS's oversight (and, hence, governing) body. According to its Charter, the Basel Committee's mandate is '*to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability*'[13]. In substance, the BCBS is the primary global standard setter body for prudential regulation and supervision of credit institutions, and provides a forum for cooperation on banking supervisory matters at the international level.

1.1. The 'Basel Process' role in the global policy-making cycle

In fulfilling its tasks of monetary and financial stability and cooperation at the international level among central banks, the BIS plays a fundamental role in the international financial architecture. This is due to the close links existing between monetary and financial stability and the fact that in several countries the central bank is both the monetary authority and also the supervisory authority of one or more main sectors of the financial system. Therefore, with its various regulatory initiatives and by providing the institutional building blocks by hosting at its premises several global regulatory committees and their secretariats, the BIS represents the natural home for pursuing such international policy coordination exercise aimed at safeguarding global monetary and financial stability. Collectively, the interaction on regulatory matters by all committees and fora hosted at the BIS premises is referred to as the 'Basel Process'. The Basel Process is a key element of the international financial architecture and a critical force that has been shaping global administrative law over the last 80 years. As such, the Basel Process plays a key role in coordinating and harmonizing the multilateral monetary, supervisory and policy efforts of central banks, supervisory authorities, regulators and

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German banks (*Bass & Herz Bankhaus*, *Bankhaus Wolff KG*, and *Frankfurter Handelsbank AG*). For an analysis of this banking crisis, see Gortsos (2019); Lastra (2015), p. 290.

[10] Together with the International Monetary Fund (**IMF**) and the World Bank, both formally established in 1945 at the Bretton Woods conference, and the Organisation for Economic Cooperation and Development (**OECD**), the BIS represents one of the main international institutions (not fora) composing the global financial architecture, and also one of the oldest, being established in 1930. The BIS is currently owned by 62 central banks, representing countries from around the world that together account for about 95% of world GDP, and its mission is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a 'bank for central banks'. In fact, in relation to its banking activities, BIS costumers can only be central banks and international organisations, as it does not accept deposits from, or provide financial services to, private individuals or corporate entities. The BIS headquarter is located in Basel and BIS has two representative offices: in Hong Kong SAR and Mexico City. For an in-depth overview of the work of the BIS, also in the historical perspective, see Borio et al. (2020).

[11] Commonly, the term 'soft law' indicates legal rules whose key feature is that they formally lack any legally binding character. On the soft law nature of the Basel framework and international financial standards, see Gortsos (2019); Lastra (2015); Brummer (2015).

[12] The BCBS's Charter contains seventeen sections included in eight chapters and is in force as updated in June 2018.

[13] BCBS Charter, section 1.

market participants alike, being thus uniquely geared towards fostering global monetary and financial stability[14].

Within this framework, the Basel-based committees represent the main components at the very centre of the Basel Process. In particular, the BIS currently hosts nine committees (i.e. international regulatory fora or bodies), which pursue, in general terms, the objectives of setting global financial standards, disseminating data to national authorities and providing a forum for cooperation among their member jurisdictions. While all the nine committees have their secretariats at the BIS, six of them are assisted by a secretariat specifically dedicated to them, which prepares the assigned committee's meetings, background papers and reports, and publishes the committee's technical work. While these six committees have their own respective internal governance structures, membership rules and reporting lines, and their agendas are guided by different groups of central banks and supervisory authorities, they all ultimately report to the Board of Directors of the BIS and they operate, from an institutional perspective, under the Monetary and Economic Department of the BIS[15]. On the other hand, the remaining three committees, while having their secretariats at the BIS, have their own governance structure and report only to their members (and not to the BIS Board of Directors)[16]. In particular, the standard-setting activities of the BCBS, together with the IAIS and the IADI (as well as the IOSCO, through the Joint Forum), encompass the core regulatory production of the global financial system, as the standards of these international fora are implemented into the national frameworks of virtually all countries around the world[17]. Indeed, despite their different reporting structures and individual constituencies, their embeddedness into the Basel Process and the BIS, acting as a forum for discussion and a platform for cooperation among policymakers, facilitates

[14] It is worth mentioning that there is no commonly shared definition of the term 'financial stability', towards which macroprudential policies would be geared. While some authors define it as the opposite to the concept of 'financial instability' by referring to episodes of 'financial crises' and to the robustness of the financial system to external shocks, or to shocks originating within the financial system, or, again, in relation to the concept of systemic risk and its sources, academic literature suggests that financial stability can be understood, in its core, as a state in which each part of the financial system can perform its tasks without major disruption. On the various definitions of the term 'financial stability', see Bauerschmidt (2020); Constâncio, ed., et al. (2019); CGFS (May 2010), p. 17, and extensive references included therein.

[15] Such committees are: i) the BCBS, which develops global regulatory standards for banks and seeks to strengthen micro- and macro-prudential supervision, ii) the Committee on the Global Financial System (**CGFS**), which monitors and analyses issues relating to financial markets and systems, iii) the Committee on Payments and Market Infrastructures (**CPMI**), which establishes and promotes global regulatory/oversight standards for payment, clearing, settlement and other market infrastructures, and monitors and analyses developments in these areas, iv) the Markets Committee, which monitors developments in financial markets and their implications for central bank operations, v) the Central Bank Governance Forum (**CBGF**), which examines issues related to the design and operation of central banks, and vi) the Irving Fisher Committee on Central Bank Statistics (**IFC**), which addresses statistical issues relating to economic, monetary and financial stability.

[16] Such committees are: i) the FSB, which is responsible for coordinating the work of national authorities and international standard-setters in promoting the implementation of effective regulatory and financial sector policies, and for setting global standards relating to the resolution regime of banks, ii) the International Association of Deposit Insurers (**IADI**), which sets global standards for deposit insurance systems and promotes cooperation on deposit insurance and bank resolution arrangements, and iii) the IAIS, which sets global standards for the insurance sector to promote effective and globally consistent regulation and supervision of insurance companies.

[17] The increasing liberalization and internationalization of financial markets during the past four decades led to a hybridization of financial institutions' business models and to the erosion of the dividing lines between banks, investment firms and insurance companies. As a result, closer cooperation between the national supervisory authorities dealing with the specific segment of such markets became a pressing priority. In response to this challenge, the IOSCO (established in 1983 and currently located in Madrid) became involved more actively in the Basel Process with the explicit aim to develop global financial standards in closer coordination with the BCBS and IAIS. Accordingly, in 1996, a Joint Forum composed by these three regulatory committees was established. On the Basel Process, see Bieri (2009), p. 312 ff.

coordination in setting global standards. This soft law model of global regulatory production has proved to work particularly well for financial markets' regulation as it produces desirable outcomes such as speed, flexibility and experience, which are crucial factors in regulating ever-changing and highly complex economic and legal phenomena such as financial institutions' business activities.

As convergence of financial markets and banking services continued throughout the 1990s, the G-20, supported by the IMF and World Bank, recognised the need for more coordination at the international level in these areas. As a response, in 1999, a more comprehensive framework for coordinating national financial policy efforts was established under the monitoring of the predecessor of the FSB, that is the Financial Stability Forum (**FSF**)[18]. As mentioned, the FSB secretariat is hosted at the BIS premises, but is operationally independent from the latter and only reports to its members and G20 Ministries. In the current model of the global financial architecture, the FSB, thus, represents the highest level in the construction of the Basel Process, bringing together the experience of Ministries of Finance, central banks, supervisory authorities and international institutions and fora (with their multiple committees) with the goal to coordinating the policy efforts of its various members to promote international monetary and financial stability, ensure the implementation of global soft-law standards, improve the functioning of financial markets and reduce systemic risk[19].

In this context, the six Basel-based committees that are fully integrated into the BIS architecture are overseen by three senior groupings and ultimately report their work to the Board of Directors of the BIS[20]. Such groupings are:

- the Global Economy Meeting (**GEM**), which comprises the Governors of 30 BIS member central banks in major advanced and emerging market economies that account for about four fifths of global GDP[21]. Its tasks consist of providing oversight to three BIS-based committees − the CGFS, the CPMI and the Markets Committee − by appointing their chairs, deciding on

[18] The FSF had originally been set up in 1999 following the currency and financial crisis in South-East Asia beginning in July 1997. The FSF consisted of the Finance Ministries, central banks and supervisory authorities of G7 countries, as well as Australia, Hong Kong SAR, The Netherlands, Singapore and Switzerland (which joined in 2007). Additional members were the IMF, the World Bank, the BIS (including the BCBS, the IAIS, the CGFS and the CPMI), the ECB, the OECD, the IOSCO and the International Financial Reporting Standards Foundation (**IFRS Foundation**). The FSF most significant contribution was the establishment of a 'compendium of standards' governing all the principal aspects of international financial regulation. Following the outset of the 2007-08 global financial crisis, at the G-20 London Summit in April 2009 it was decided to replace the FSF with the FSB in order to place such international fora on stronger institutional grounds and enhance its effectiveness as global cooperation and standard-setting mechanism. For a detailed analysis of the FSB's role in the global financial architecture, see Chapter 1, Paragraph III.

[19] It is worth mentioning that there are multiple international organisations that, also at the regional level, contribute towards greater harmonization of financial policies and standards. These can be grouped together as: i) regional economic organisations, such as the European Union (**EU**), the Association of Southeast Asian Nations, the Arab League, Mercosur and the Southern African Development Community, ii) regional monetary unions, such as the Economic and Monetary Union within the EU, the West African Economic and Monetary Union, the Economic and Monetary Community of Central Africa and the Eastern Caribbean Currency Union (*de facto* established), and iii) regional development banks, such as the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank and the Inter-American Development Bank.

[20] The Board of Directors of the BIS is responsible for determining the strategic and policy direction of the BIS and fulfilling the specific tasks given to it by the BIS Statute. The BIS Board of Directors meets at least six times a year and may have up to 18 members, including 6 *ex officio* Directors, comprising the central bank Governors of Belgium, France, Germany, Italy, the United Kingdom and the United States. Such members may jointly appoint one other member of the nationality of one of their central banks. 11 Governors may be elected to the Board of Directors from all the remaining 56 member central banks. The current Chairman is Jens Weidmann (President of the *Deutsche Bundesbank*), who was re-elected on 31 October 2018 for a second three-year term. The full list of BIS members is available on the BIS website.

[21] The full list of GEM members and observers is available on the BIS website.

the publication of their reports and providing guidance on work priorities, as well as monitoring and assessing developments, risks and opportunities in the world economy and the global financial system;

- the All Governors' Meeting, which includes all 62 BIS member central banks, and oversees the work of two committees − the CBGF and the IFC − whose memberships are broader than the GEM's;
- the GHOS, which provides oversight to the BCBS and it comprises the central bank Governors and non-central bank heads of supervision from BCBS member jurisdictions[22].

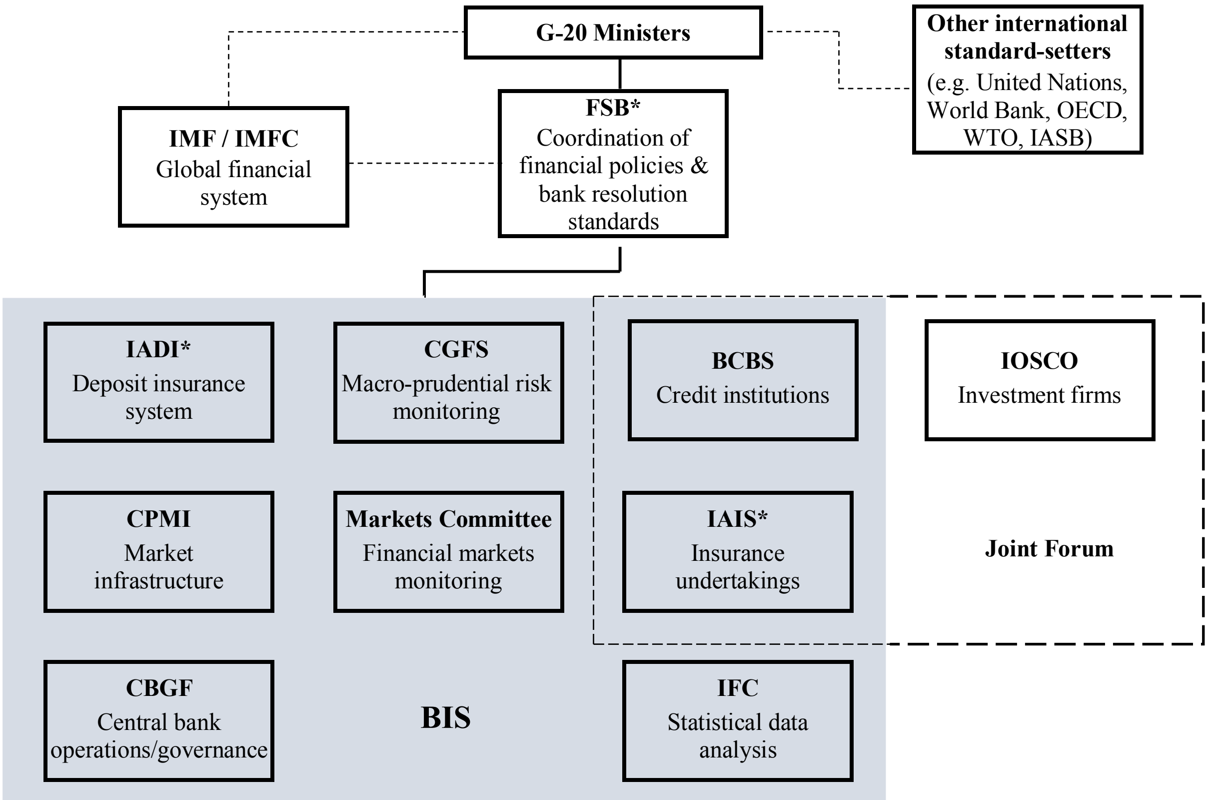

Figure 1. Global financial regulatory architecture and the Basel Process.
** Independent fora whose secretariats are hosted by the BIS, but do not directly report to the BIS or its members.*
Source: Author's illustration.

As mentioned above, one of the most significant BIS-based committee is the BCBS (including its roughly 30 technical working groups, virtual networks and task forces), which is responsible for what is undoubtedly the most prominent initiative arising out of the Basel Process, namely the comprehensive package of post-2007 financial crisis reforms for internationally active banks collectively known as 'Basel III' (as finalised in 2017), and its capital adequacy framework[23]. The distinctive character of this institutional arrangement, often referred to as 'transgovernmental forum' or 'network of national regulators'[24], and responsible for formulating global micro- and macroprudential banking standards and best practices, is discussed in more detail hereinafter.

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[22] For more details in relation to the GHOS and the BCBS, see Chapter 1, Paragraphs 1.1.1. and 1.1.2.
[23] For an in-depth analysis of the Basel III framework, see Chapter 1, Paragraph II.
[24] See Quaglia (2015), p. 14.

1.1.1. *Membership and composition of the Basel Committee*

Under its 2013 Charter, the BCBS allows only public organizations with direct banking supervisory authority and central banks to become its members[25]. After consulting the Committee, the BCBS Chairman may invite international organisations or organisations from non-member jurisdictions to become observers[26]. The initial members of the Committee, from its establishment in 1974 until June 2009, were on the one hand, the central banks of the G10 members, Switzerland and Spain (since 2001)[27], and on the other hand, banking supervisory authorities in these countries (to the extent that their central bank was not exclusively responsible for the conduct of micro-prudential banking supervision)[28], as well as the financial authority of Luxembourg[29]. Following the outbreak of the 2007-08 global financial crisis (**GFC**), the BCBS, in its meeting of 10-11 March 2009, decided to broaden its membership upon an invitation by the G20 leaders to all international fora to review their composition. The expansion was completed three months later[30]. New members became the central banks and (as appropriate) the banking supervisory authorities from the twelve G20 members that were not represented in the BCBS yet. Therefore, the Committee is currently participated by senior representatives from the central banks and (as appropriate) the banking supervisory authorities of the following 28 member jurisdictions: all 19 members of the G20, the three G10 members which are not G20 members (Belgium, Sweden and Switzerland), Hong Kong SAR, Luxembourg, the Netherlands, Singapore and Spain, as well as the EU (another G20 member)[31], which is represented by the European Central Bank (**ECB**) and the Single Supervisory Mechanism (**SSM**)[32]. In addition to the member jurisdictions, institutions from three states participate in the Committee as 'country observers'[33], as well as the BIS, the Basel Consultative Group[34], the European Banking Authority (**EBA**), the European Commission (**EC**) and the IMF[35].

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[25] BCBS Charter, section 4.

[26] The full list of BCBS members and observers is set on the Committee's website by the BCBS Secretariat.

[27] These central banks are also the most important shareholders of the BIS.

[28] The inclusion of both monetary and supervisory authorities in the composition of the BCBS was decided on the consideration that central banks are competent for safeguarding the stability of the banking system (which is the main policy objective of the Committee), even in countries that have assigned monetary and supervisory functions to different public authorities or bodies. For an overview of the scholarly debate on the 'principle of separation' and its functional implications, see, among others, Eijffinger and Nijskens (2012); Smits (1997); Goodhart and Schoenmaker (1995).

[29] Luxembourg, albeit not a G10 member, was included mainly because of its great importance as an international financial centre and also partly as a result of its monetary union with Belgium (on this argument, see Walker (2001), pp. 42-43). Until 1998, it participated only through its 'Monetary Institute', which was not a central bank. Even today the Central Bank of Luxembourg, whose establishment in 1998 was deemed necessary following Luxembourg's accession in the EU monetary union, is not a member of the Committee. See Gortsos (2019), p. 110.

[30] See BCBS press release dated 10 June 2009 '*Basel Committee broadens its membership*'.

[31] It is worth mentioning that, unlike other international financial regulatory fora such as the IOSCO or IAIS, the BCBS does not have a universal membership and, therefore, not all the EU Member States sit on the BCBS. Indeed, senior representatives from 8 EU Member States only are currently permanent members of the BCBS.

[32] The SSM represents the new prudential architecture responsible for supervising 'significant' banks within the Eurozone. It was established by virtue of Council Regulation (EU) No 1024/2013 of 15 October 2013, and it became operational on 4 November 2014. For an in-depth analysis of the organisational structure, tasks and powers of the SSM, see Chapter II.

[33] These institutions are the Central Bank of Malaysia, the Central Bank of the United Arab Emirates, the Central Bank of Chile and the Chilean Banking and Financial Institutions Supervisory Agency.

[34] For more information in relation to the Basel Consultative Group, see Paragraph 1.1.2.

[35] According to the BCBS Charter, section 4, membership and observer status must be reviewed periodically. In accepting new members, due regard must be given to the importance of their national banking sectors to international financial stability.

According to the Committee's Charter[36], member jurisdictions are committed to the following responsibilities:

- work together to achieve the Committee's mandate and, in particular, promote financial stability and continuously enhance the quality of banking regulation and supervision in their jurisdiction;
- actively contribute to the development of standards, guidelines and sound practices, implement and apply these standards in their domestic jurisdictions within predefined timeframes, as well as undergo and participate in BCBS reviews to assess the consistency and effectiveness of domestic rules and supervisory practices in relation to these standards;
- promote not solely national interests but also the interests of global financial stability, while participating in the work and decision-making of the Committee.

It is worth mentioning that, since the adoption of the first Basel capital adequacy framework in 1988[37], BCBS standards are usually not only implemented by member states, but also by third countries, as they are considered to be the global benchmark in banking regulation[38]. As such, third countries who unilaterally decide to adopt the BCBS standards do not possess any formal representation or voting powers within the Committee, nor they participate in the discussions and decision-making processes prior to the adoption of the standards by the BCBS and the GHOS. In this sense, the prudential standards issued by the BCBS, although not legally binding, tend to be rather detailed and are *de facto* accepted worldwide.

1.1.2. Organisational structure and responsibilities of the Basel Committee

The internal organisational structure of the BCBS comprises i) the Committee, ii) groups, working groups, virtual networks and task forces, iii) the Chairman, and iv) the Secretariat. Starting from the first component, the Committee is the ultimate decision-making body of the BCBS with '*responsibility for ensuring that its mandate is achieved*'. Specifically, it is responsible for[39]:

- developing, guiding and monitoring the BCBS work programme within the general direction provided by GHOS;
- establishing and promoting standards, guidelines and sound practices[40];
- establishing and disbanding groups, working groups and task forces; approving and modifying their mandates; and monitoring their progress;
- recommending to the GHOS amendments to the BCBS Charter; and
- deciding on the organisational regulations governing its activities.

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[36] BCBS Charter, section 5.

[37] On the Basel I Accord, see Chapter 1, Paragraph 1.3.

[38] The implementation of the BCBS standards by third countries is further discussed under Chapter 1, Paragraph 2.4.

[39] BCBS Charter, section 8.

[40] According to the BCBS Charter, sections 12, 13 and 14, the Committee sets 'standards' for the prudential regulation and supervision of banks. The BCBS expects full, timely and consistent implementation of its standards by BCBS members and their internationally active banks (on this, see Chapter 1, Paragraph 1.2.). 'Guidelines' generally supplement BCBS standards by providing additional guidance for the purpose of their implementation in relation to prudential regulation and supervision of banks (in particular internationally active banks). 'Sound practices' generally describe actual observed practices in the market, with the goal of promoting common understanding and improving supervisory or banking practices. BCBS members are encouraged to compare these practices with those applied by themselves and their supervised institutions to identify potential areas for improvement.

The Committee meets four times per year, but the Chairman retains the right to convene additional meetings as necessary[41]. Decisions by the Committee are taken by consensus among its members, and decisions of relevant interest are communicated through the BCBS's website and accompanied, when appropriate, by a Committee's press statement[42].

Second, the Committee's work is largely organised around groups[43], working groups[44], virtual networks[45] and task forces[46]. In substance, day-to-day technical work of the Committee is implemented by five different standard-setting and research-based groups, each of them having a number of specialised sub-working groups and task forces. Such groups are:

1) the Policy Development Group (**PDG**), responsible for developing policies that promote a sound banking system and high supervisory standards[47];
2) the Supervision and Implementation Group (**SIG**), who has the primary objectives to foster, through the Regulatory Consistency Assessment Programme[48], the timely, consistent and effective implementation of the Committee's standards, and to advance improvements in banking supervision, particularly across the BCBS's member jurisdictions[49];
3) the Basel Consultative Group (**BCG**), who provides a forum for deepening BCBS's engagement with supervisors around the world on banking supervisory issues[50];
4) the Macroprudential Supervision Group (**MPG**), who monitors systemic risk and global developments that relate to macroprudential and systemically important banks' supervision[51];

[41] All BCBS members and observers are entitled to appoint one representative to attend these meetings, which are presided by the Chairman. The representatives must be senior officials of their organisations (e.g. at the level of head of banking supervision, head banking policy/regulation, deputy governor, or head of financial stability department) and have the authority to commit their institutions.
[42] For a critical analysis on the partial lack of transparency, public access to information, reporting and liaisons with non-governmental organizations (**NGOs**) by the BCBS in the context of its decision-making processes, see Quaglia (2015), p. 27 ff.
[43] Groups are composed of senior staff from member jurisdictions that guide or undertake themselves major areas of the Committee's work. They report directly to the Committee, form part of its permanent internal structure and hence operate without a specific deliverable or end date.
[44] Working groups consist of experts from member jurisdictions that support the technical work of BCBS groups.
[45] Virtual networks serve as an expert group that are called upon as needed by the parent group or the Committee. The primary function of virtual networks is to monitor existing policies.
[46] Task forces are created to undertake specific tasks for a limited time and are generally composed of technical experts from BCBS members. Of particular importance are the 'high-level task forces', which are created by the Committee itself, consist of BCBS representatives and deal with specific issues requiring prompt attention. Task forces are temporary in nature and do not form part of the Committee's permanent structure.
[47] Due to its broad mandate, the PDG is composed of twelve specialised sub-working groups tasked with developing policy work at the technical level on a wide range of banking regulatory issues, from the definition of regulatory capital to liquidity standards and best risk management practices.
[48] On the objectives of the Regulatory Consistency Assessment Programme, see Chapter 1, Paragraph 1.2.
[49] The SIG is composed of eight sub-working groups developing guidance and acting as fora for discussions in relation to regulatory matters such as supervisory colleges, Pillar 2 requirements and stress testing.
[50] The BCG facilitates broad supervisory dialogue with non-member countries on new Committee's initiatives by gathering senior representatives from various countries, international organisations and regional groups of banking supervisors that are not BCBS members. Currently, central banks and supervisory authorities from 29 different countries non-represented on the Committee are part of the BCG, together with 12 regional supervisory groups and international organisations. The full list of BCG members is available on the BIS website.
[51] In particular, the MPG is tasked with developing policy proposals to fill gaps and address inconsistencies in the framework of macroprudential and systemically important banks' supervision, and provides guidance to other working groups on these issues.

5) the Accounting Experts Group (**AEG**), who helps ensuring high quality international accounting standards and practices, and supports a common international interpretation and harmonised application of those standards and practices[52].

The third component of the Committee's internal organisational structure is the Chairman. According to section 10 of the BCBS Charter, the BCBS Chair's main responsibilities are to direct the work of the Committee in accordance with its mandate, including to i) convene and chair BCBS meetings, ii) monitor the progress of the BCBS work programme and provide operational guidance between meetings to carry forward the decisions and directions of the BCBS, iii) report to the GHOS, and iv) represent the BCBS externally and be its principal spokesperson[53].

The last main body composing the internal organisational structure of the BCBS is the Secretariat, which is provided by the BIS. Its main responsibilities include, among others, to provide support and assistance to the other above-mentioned components of the internal BCBS's organisational structure, ensure the timely and effective information flow to all BCBS members, and facilitate coordination across groups, working groups, virtual networks and task forces[54].

As mentioned under Paragraph 1.1., the Committee, from a governance standpoint, reports day-to-day work developed by its five standard-setting and research-based groups to the GHOS (the Committee's governing body), which is composed of central bank Governors and non-central bank heads of supervision of BCBS member jurisdictions, and seeks its endorsement for major decisions[55]. In addition, the GHOS approves the BCBS's Charter and any amendments thereto, provides general direction for its work programme, and appoints the BCBS Chair from among its members[56].

1.2. The implementation process of the Basel standards

As discussed, an important commitment on the side of BCBS members is the implementation of the Committee's banking standards into their national frameworks. If internationally agreed standards are not properly implemented at the national level, they will ultimately have no impact in practice. At the same time, even though BCBS standards have a legally non-binding nature, mature economies tend to implement them as they fear to possibly lose the competitive edge of their domestic banking markets, due to the fact that excessively lose banking regulations, particularly after the economic deterioration that followed the GFC, may have a counter-productive effect and result in reputational

[52] With its work, the AEG (and its only subgroup on audit) contributes to sound banking risk management, explores key audit issues from a banking supervision perspective and enhances market discipline. In addition, it helps ensuring high quality audit and ethics standards for auditors, with the aim of ensuring high quality bank audits and regular communication of information between banking supervisors and audit firms. It is worth mentioning that global accounting standards, being a separate regulatory area from banking prudential supervision, are adopted by the IFRS Foundation, an international forum located in London and not embedded into the Basel Process. Therefore, regarding the development of international accounting standards, in September 2017 the BCBS and the IFRS Foundation have entered into a Memorandum of Understanding that formalises the mutual interaction at both the strategic and working levels.

[53] Currently, this position is held by Mr. Hernández de Cos, Governor of the Bank of Spain, who was appointed on 7 March 2019 and succeeded to Stefan Ingves (Governor of *Sveriges Riksbank*). The BCBS Chairman is appointed by the GHOS from among its members for a term of three years that can be renewed once. If the BCBS Chair ceases to be a GHOS member before the end of his/her term, the GHOS will appoint a new Chair.

[54] See BCBS Charter, section 11.

[55] Currently, the Chairman of the GHOS (who is a different representative than the BCBS Chairman) is François Villeroy de Galhau, Governor of the Bank of France.

[56] BCBS Charter, section 6.

sanctions from investors and market participants, in this way harming foreign investment opportunities and the domestic economy. Therefore, BCBS members, to avoid peer-to-peer pressure, possible capital outflows, loss of correspondent banking relationships and/or a crisis of confidence in the face of increasingly interconnected and globalised banking markets[57], commit, as a necessary trade-off, to the implementation of strict regulations, which is the option that in their views bear the least social cost among all those available. In this sense, there is a plausible connection between the operation of global soft law and game theory[58]. As a result, the implementation, application and enforcement of banking prudential standards represent a core element of the BCBS policy cycle[59].

In seeking to achieve the overarching objective of safeguarding global financial stability and ensuring a fair level playing field among internationally active banks, every BCBS member is called to implement the Committee's standards in a full, timely and consistent manner. Full implementation means that the full scope of the agreed reforms is expected to be implemented; Timely implementation means that global reforms have to implemented no later than the agreed dates; Consistent implementation means that the Basel framework is expected to be implemented in a faithful and compliant manner (in terms of both the letter and spirit of the standards). If, under exceptional circumstances, deviation from literal transposition into national legal frameworks is unavoidable, BCBS members should seek the greatest possible equivalence of standards and their outcome. Importantly, the global standards set out in the Basel framework are to be considered as the minimum financial safety net that need to be implemented by BCBS members. Jurisdictions are free to go beyond such baseline if the size and structure of their banking system and the associated risks warrant additional measures – something that in the literature is referred to as 'gold-plating' or 'super-equivalent'. In principle, 'gold-plating' or 'super-equivalent' measures would reinforce global financial stability, under the assumption that BCBS members promote the interests of the global financial system and not solely their own national interests[60]. Appropriate implementation of standards is of key importance as a non-consistent adoption of the Basel standards across jurisdictions would result, among others, in market fragmentation and cross-border regulatory arbitrage[61].

Not possessing any formal supranational authority or legal personality, the BCBS is not tasked with binding powers to follow-up on jurisdictions that do not implement its supervisory standards. The power of the Committee's standards lies therefore in moral suasion and peer pressure, i.e. the

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[57] As of 2020, global cross-border bank claims are estimated to exceed USD 30 trillion, including claims on not only other banks but also non-bank counterparts. If certain parts of this globally interconnected banking network are not subject to the same degree of resilience, this could result in a build-up of risks in certain banking systems, which could ultimately impede the continued provision of credit across jurisdictions. Data is drawn from Hernández de Cos (2020), p. 3.
[58] On this argument, see Lee (2014), p. 607.
[59] While the features of such a cycle may differ across organisations, they generally comprise the following sequential elements: i) identifying a policy issue/objective; ii) developing and appraising possible policy options; iii) implementing and monitoring the finalised policy measures; iv) evaluating the effectiveness of the policy measures and the extent to which they meet their objectives; and v) incorporating any insights and lessons learned for future policymaking. In this sense, see Hernández de Cos (2020), p. 3.
[60] See BCBS member jurisdictions' commitments under section 5 of the BCBS Charter.
[61] As noted by the FSB, the impact on market fragmentation as a result of a non-consistent Basel III implementation could include: i) creating an unlevel playing field among banks that can result in a race-to-the-bottom in terms of regulatory standards and/or supervisory practices, which in turn can have adverse consequences for the soundness of the banking system; ii) overstating the capital and liquidity ratios reported by banks in jurisdictions that have not implemented Basel III consistently, which would erode comparability across banks and impair market discipline; and iii) adding operational costs and complexity for internationally active banks. See FSB (Jun 2019).

common willingness that member jurisdictions will adopt the standards in order to minimise competitive inequality among internationally active banks, underpin public confidence in the banking sector and strengthen financial stability. At the same time, in order to achieve such level playing field objective and ensure implementation of its standards in the most effective way, in 2012 the BCBS agreed to establish the Regulatory Consistency Assessment Programme (**RCAP**) and mandated the SIG to implement it. The objectives of the RCAP – which cover overall around 90% of the world's banking assets – are threefold: i) monitor the timely adoption of standards by member jurisdictions, ii) assess the completeness and consistency of the implemented standards, and iii) evaluate the outcomes of the application of these standards. In particular, the RCAP consists of two complementary workstreams:

a) On the one hand, the BCBS monitors the implementation status of the Basel Accords in member jurisdictions and submits semi-annual reports to G20 leaders[62]. These monitoring reports, based on information submitted by BCBS members' authorities, provide a high-level overview of Committee members' progress in adopting the Basel standards and their publication provides an incentive for member jurisdictions to adopt such standards in a timely manner;
b) On the other hand, all BCBS members undergo an assessment of the completeness and consistency of their domestic laws with the Basel framework. The jurisdictional assessments consist of peer review exercises carried out by the Committee's staff that assess the extent to which domestic regulations are aligned with the minimum Basel standards and identify any deviations from the Basel framework. The assessment reports are published and include an overall compliance grade[63], which provides an incentive for member jurisdictions to take corrective actions to address findings identified in the assessments[64]. Following the publication of the RCAP report, the Committee carries out follow-up assessments, and publishes the report, to track the corrective actions taken by the relevant BCBS member[65].

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[62] As at April 2020, the BCBS has issued 17 progress reports on the adoption of its standards by member jurisdictions, the last one being published in October 2019.

[63] RCAP assessments are summarised according to a four-grade scale: i) 'compliant', which means that no material differences have been identified that would give rise to prudential concerns or provide a competitive advantage to banks; ii) 'largely compliant', that is only minor provisions of the Basel framework have not been satisfied and regulatory differences have a limited impact on financial stability or the international level playing field; iii) 'materially non-compliant', which means that key provisions of the Basel framework have not been satisfied and regulatory differences could materially impact financial stability or the international level playing field; iv) 'non-compliant', that is Basel standards have not been adopted and/or regulatory differences could severely impact financial stability or the international level playing field. For an overview of the RCAP assessment methodology and the RCAP questionnaires, which BCBS members need to complete ahead of the assessment, see BCBS (Mar 2018).

[64] To date, the BCBS has published assessment reports for all its member jurisdictions regarding their implementation of the capital requirements, liquidity coverage ratio and global systemically important bank framework. In 2018, the BCBS started assessing the consistency of implementation of the net stable funding ratio and the framework for measuring and controlling large exposures, the review of which is expected to be completed for all member jurisdictions in 2021. The Committee will then commence its review of members' implementation of the leverage ratio framework and the revised risk-weighted capital framework. See Hernández de Cos (2020), p. 5.

[65] While the overall results of RCAP remain positive and the majority of BCBS jurisdictions have been rated as 'compliant' or 'largely compliant' for almost all five subject areas covered so far, it is worth mentioning that to date the EU (that is, the 8 EU member states represented at the Committee level) is the only jurisdiction assessed as 'materially non-compliant' with respect to one subject area covered by the RCAP, i.e. risk-based capital. This is due to certain findings in relation to the internal ratings-based approach for credit risk pertaining primarily to the treatment of exposures to small and medium enterprises (**SMEs**), corporates and sovereigns, and the EU counterparty credit risk framework,

According to 2020 BCBS data, the RCAP for the capital framework, liquidity coverage ratio and global systemically-important banks framework identified a total of 1,450 deviations, of which around 60% were rectified during the assessment. Of the remaining deviations, 85% have been assessed as not material, i.e. not expected to give rise to concerns related to financial stability or the international level playing field[66]. In addition, the BCBS regularly carries out: i) thematic reviews assessing the implementation of the Basel standards at the individual bank level, in order to ensure that prudential ratios and risk-weighted assets (**RWAs**) for credit risk, market risk and counterparty credit risk are calculated consistently by banks across jurisdictions, and ii) quantitative impact studies monitoring the effects and the dynamics that the Basel standards display on banking markets in relation to risk-based capital ratios, the leverage ratio and the liquidity metrics.

1.3. The first international capital adequacy framework

According to legal scholarship, the relevance of banking capital regulation lays primarily in the fact that it forces banks to internalise the externality of the social cost of bankruptcies by requiring them to hold more equity than they would if they only considered the private costs of insolvency[67]. It comes with no surprise, therefore, that since its establishment in 1974, the definition of banking capital and capital adequacy ratios have been the main focus of the BCBS's activities[68]. In particular, a major development in the regulatory operations of the Basel-based committee occurred in the early 1980s, when the onset of several Latin American sovereign debt crises, coupled with concurrent banking crises with international ramifications, such as *Banco Ambrosiano* in 1980 and *Continental Illinois* in 1984[69], heightened the G-10 and the BCBS's concerns that capital ratios of the main international banks (particularly US-based ones) were alarmingly deteriorating due to their credit exposure to such sovereigns.

In order to halt the erosion of capital ratios in banking systems and ensure fair competition among internationally active banks in a context of increasingly globalised financial systems and expansion into new cross-border business lines, the G-10 mandated the BCBS to commence policy work to achieve greater convergence in the definition of banking capital, the removal of regulatory arbitrage issues arising from existing differences in national capital requirements, and the development of a weighted approach to the measurement of banking risks (both on and off-balance sheets). In other

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which provides an exemption from the Basel framework's credit valuation adjustment capital charge for certain derivatives exposures. See BCBS (Dec 2014).

[66] Hernández de Cos (2020), p. 6.

[67] See Lee (2014), p. 609.

[68] During its first years of operations, one important aim of the Committee's work, together with the definition of risk-based capital, was to close gaps in international supervisory coverage so that no banking establishment would escape supervision and would be subject to adequate supervision across member jurisdictions. To this end, in May 1983, the Committee published a document called '*Principles for the supervision of banks' foreign establishments*' (previously known as '*Concordat*'), which set out principles for sharing supervisory responsibility for banks' foreign branches, subsidiaries and joint ventures between host and parent (or home) supervisory authorities. Such document was then augmented in April 1990 by means of the supplement '*Exchanges of information between supervisors of participants in the financial markets*', and in July 1992 through the '*Minimum standards for the supervision of international banking groups and their cross-border establishments*'. The momentum gained by the publication of these standards lead to the release, in October 1996, of the report '*The supervision of cross-border banking*', which presented concrete proposals for overcoming the impediments to effective consolidated supervision of the cross-border operations of international banks. Such report was subsequently endorsed by supervisory authorities from 140 countries.

[69] On these banking crises, see Gortsos (2019), p. 41, and references mentioned therein.

words, the aim of the G-10 was to ensure that the benefits of the liberalisation of global capital flows and capital markets – which began after World War II and substantially speed up with banking and financial deregulation from the 1980s – were accompanied by assurance on the exogenous risks that might be imported by market players operating on a cross-border level. The outcome of this work was the publication by the BCBS, in December 1987, of a consultative paper aimed at strengthening the capital base of international banks in order to enhance the stability of global financial systems. Based on feedback on this paper, a capital measurement system commonly referred to as the 'Basel Capital Accord', or 'Basel I', was approved by the G-10 Governors and released to international banks in July 1988.

The key assumption of Basel I, as carried forward also in the future reviews of the framework, is that the main instrument to limit excessive risk-taking behaviours and potential losses by banks and to protect their creditors (including depositors) is to set a minimum risk-based capital requirement to be met by banks at all times[70]. In this sense, the core principle of the Basel 'capital adequacy' regime is that the higher the amount of own funds a bank holds, the higher its solvency ratios and the likelihood that it will withstand financial stress, making it less likely to cause system-wide problems. In particular, Basel I requires internationally active banks[71] to maintain, by end-1992 onwards, a ratio of eligible regulatory capital to RWAs no lower than 8%. To achieve this goal, on the one hand, Basel I harmonises, for the first time at the international level, the definition of banking capital, providing that only certain categories of financial instruments are eligible to constitute the capital base of a bank. Therefore, subject to supervisory approval, banks are now called to classify, to meet the 8% capital to RWAs ratio, eligible financial instruments into two different capital tiers (i.e. Tier 1 and Tier 2), which reflect the different funding sources and the quality – that is, the capacity to absorb losses – of the given financial instruments[72].

On the other hand, Basel I introduces a risk weighted matrix according to which the level of capital to be held by banks is to be determined against broad categories of assets (i.e. exposures) weighted according to their relative riskiness[73]. The amount of an asset to be included in the RWAs' total would

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[70] It is worth mentioning that capital adequacy, though important, is one (but not the only one) of a number of factors to be taken into account when assessing the soundness of a bank. As recognised also by the BCBS, capital ratios, if judged in isolation, may become a misleading indicator to relative strength of banks. In fact, appropriateness of governance structures and internal functions, sound business models or liquidity buffers are, among others, key elements that likewise ensure the viability of credit institutions. See BCBS (Jul 1988), p. 2.

[71] For an analysis of the scope of the Basel framework and its proportionality features, see Chapter 1, Paragraph 2.4.

[72] Following an approach that will be, in its main features, consolidated also in the future reviews of the Basel framework, Basel I provides that the first tier (Tier 1) of the banks' capital base shall include only permanent shareholders' equity (i.e. issued and fully paid ordinary shares/common stock and perpetual non-cumulative preference shares) and disclosed reserves (i.e. audited post-tax reserves created or increased by appropriations of retained earnings or other surplus, such as share premiums, retained profit or legal reserves). The main difference with the capital components of the second tier (Tier 2) is that Tier 2 financial instruments are not basic equity but supplementary hybrid capital instruments, which combine characteristics of equity capital and debt (such as preference shares or subordinated bonds). As such, Basel I provides that Tier 2 capital is composed of undisclosed reserves, revaluations of fixed assets and equity securities, general loan-loss reserves, hybrid capital instruments and subordinated term debt. For all the constituents of the new Basel I two tiers constituting the capital base of international banking systems, see BCBS (Jul 1988), Annex 1, Letter D.

[73] The Basel I structure of risk weights follows a simple approach by providing only five weights, or 'risk buckets', for all categories of on-balance-sheet exposure, namely - 0, 10, 20, 50 and 100%. For example, cash and claims on central governments and central banks denominated in national currency are assigned to a risk weight of 0%, whereas claims on domestic public-sector entities (excluding the central government) are assigned to a risk weight of 0, 10, 20 or 50% at national discretion. At a riskier point in the matrix, a 20% weight is assigned to short-term bank lending, while loans fully secured by mortgage on residential property are assigned to a risk weight of 50%. At the opposite side of the metrics,

be equal to the asset's value multiplied by the risk weight applicable to that type of asset. Therefore, the riskier a bank's asset, the more capital such bank would be required to hold – the so-called 'risk weighting' of assets. The final bank's risk-based capital ratio is to be calculated by dividing the bank's capital (the numerator) by the bank's RWAs (the denominator). The 8% minimum capital ratio, of which Tier 1 capital has to amount at least to 4%, applies to internationally active banks both on a consolidated basis (i.e. including all banking and financial subsidiaries of the group), as well as on a stand-alone basis, that is every bank of the group must meet the Basel capital requirements individually.

While such an approach to banks' risk management certainly represented a significant innovation in the international banking regulation, the BCBS, in its first capital framework, did not address the full spectrum of banking risks that are normally faced by banks in their business operations. Indeed, Basel I required banks to raise capital to cover only for assets associated to credit risk (i.e. the risk of counterparty failure), while market risk was added only at a later stage (in 1996). Assets associated to other categories of risks, notably investment risk, liquidity risk, exchange rate risk or concentration risk, were not subject to harmonised weighting rules and will be gradually covered only in future reviews of the Basel framework. Therefore, following the adoption of Basel I[74], supervisory authorities of BCBS jurisdictions still needed to assess, according to national requirements, the appropriateness of capital adequacy ratios of banks established in their jurisdictions in relation to banking risks other than credit risk.

To better assess risk-sensitivity of banks' exposures and more adequately match capital requirements to risks, the BCBS developed further the Basel I framework by issuing, in January 1996, the '*Amendment to the Capital Accord to incorporate market risks*' (the '**Market Risk Amendment**'), which took effect at the end of 1997[75]. The Market Risk Amendment is designed to incorporate into the Basel I framework a capital requirement for market risk (i.e. the risk of losses arising from movements in market prices) stemming from banks' exposures to foreign exchange, traded debt securities, equities, commodities and options[76]. An important aspect of the Market Risk Amendment is that banks, for the first time, are allowed to choose between a standardised approach

exposure riskier in nature that need full capital coverage are, *inter alia*, i) claims on the private sector, ii) claims on banks incorporated outside OECD countries with a residual maturity of over one year, and iii) real estate investments. As such, under Basel I the risk variation among assets is based on easily identifiable characteristics, such as whether the exposure is a commercial loan or a government debt. For the full list of risk weights of on-balance-sheet assets, see BCBS (Jul 1988), Annex 2.

[74] Basel I was implemented in the then European Community by way of several Directives over a number of years. Such Directives are: i) Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions, ii) second Council Directive 89/646/ EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, iii) Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions, iv) Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis, and v) Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions. For reasons of legal clarity, in 2006 the European Community will consolidate the BCBS standards into two single legal texts in the context of the implementation of the Basel II reform at the regional level (see Chapter 1, Paragraph 1.4.).

[75] It is worth mentioning that, besides the case of the Market Risk Amendment, Basel I continued to evolve over time and was subject to a series of additional regulatory changes by the BCBS. In November 1991, the framework was modified to more precisely define the general loan loss reserves that could be included in the capital adequacy ratio. In April 1995, the Committee issued another amendment, to take effect at the end of that year, to recognise the effects of bilateral netting of banks' credit exposures in derivative products and to expand the matrix of add-on factors.

[76] See BCBS (1996), p. 2.

and, subject to supervisory approval, an internal models-based approach as a basis for measuring their market risk capital requirements. The former approach makes use of specific BCBS-defined risk capital charges applied to different categories of assets (similarly to the assets' treatment under Basel I credit risk). The latter approach allows banks to use their own internal risk management models to determine their capital charges[77]. Such regulatory innovation marked the advent of proportionality in the Basel framework[78].

Ultimately, the Basel I 8% ratio of capital to RWAs was introduced not only in member jurisdictions but virtually in all countries with internationally active banking markets. In September 1993, the Committee issued a statement confirming that G10 countries' banks with material international banking business were meeting the minimum requirements set out under Basel I[79]. While BCBS's expectations to enhance financial stability by making commercial banks more capable of absorbing losses due to mandatory minimum levels of high-quality capital will be partially met, future financial crises will prove that the Basel I framework needed fundamental regulatory additions to effectively achieve its objective of safeguarding global financial stability.

1.4. From Basel I to Basel II: The three supervisory pillars

Due to progress in risk management, the increasing hybridization of banks' business models and the growing importance of cross-border banking activities, Basel I soon turned out to be too rudimentary. The five-category risk weighting system revealed to be too simplistic and based on 'one-size-fits all' classifications that did not adequately differentiate between borrowers' differing default risks. For example, a bank was required to hold the same percentage of capital for all commercial loans – whether to highly rated corporations or much riskier distressed companies – because all such loans received the same 100% risk weight rating. In addition, as Basel I was not sufficiently granular in its supervisory standards, it gave banks excessive regulatory leeway in the calculation of RWAs and enabled them to easily 'game the system' by keeping capital requirements artificially low. All of these worries became particularly acute with the Asian financial crisis in 1997, the Russian financial crisis of 1998 and the collapse of the US hedge fund Long-Term Capital Management. As a result, in June 1999, the BCBS issued a proposal for a new, more risk-sensitive, capital adequacy framework[80].

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[77] The possibility, originally offered to banks only in relation to market risk, and then extended to other categories of risks under Basel II, to calculate RWAs according to their internal risk management models instead of standardised models developed by supervisors will become one of the most heatedly debated features of the prudential framework in the context of the Basel III reform following the 2007-08 global financial crisis. For a detailed analysis, see Chapter 1, Paragraph II.

[78] On the proportionality aspects embedded into the Basel framework and international banking regulation, see A. P. Castro Carvalho et al. (2017).

[79] In the United States, according to quantitative data provided by the Federal Deposit Insurance Corporation (**FDIC**), the equity capital to RWAs ratio of US banks amounted to 5.5% in 1974, while it reached 8% in 1992, and 9.5% in 2000. See McNamara et al. (Oct 2014), p. 7.

[80] In this context, the BCBS noted '*[t]he world financial system has witnessed considerable economic turbulence over the last two years and, while these conditions have generally not been focused on G-10 countries directly, the risks that internationally active banks from G-10 countries have had to deal with have become more complex and challenging. This review of* [Basel I] *is designed to improve the way regulatory capital requirements reflect underlying risks. It is also designed to better address the financial innovation that has occurred in recent years, as shown, for example, by asset securitisation structures. As a result of this innovation,* [Basel I] *has been less effective in ensuring that capital requirements match a bank's true risk profile. The review is also aimed at recognising the improvements in risk measurement and control that have occurred*'. See BCBS (Jun 1999), p. 4.

The revised framework, considerably more complex than its predecessor[81], was released, after almost six years of intensive preparation, in June 2004 under the name of 'Basel II Accord' or 'Basel II'[82]. On the one hand, the new framework updates the minimum capital requirements under Basel I; on the other, it introduces two new components, i.e. supervisory review and market discipline, which altogether form the 'three pillars' of Basel II.

Thus, the revised supervisory framework is structured on three main components:

- minimum capital requirements, which seek to develop and expand the harmonised capital rules set out under Basel I (Pillar 1);
- a supervisory review process of banks' capital planning and the effectiveness of their risk management and internal control processes (Pillar 2);
- disclosure requirements to strengthen market discipline and encourage sound banking practices (Pillar 3).

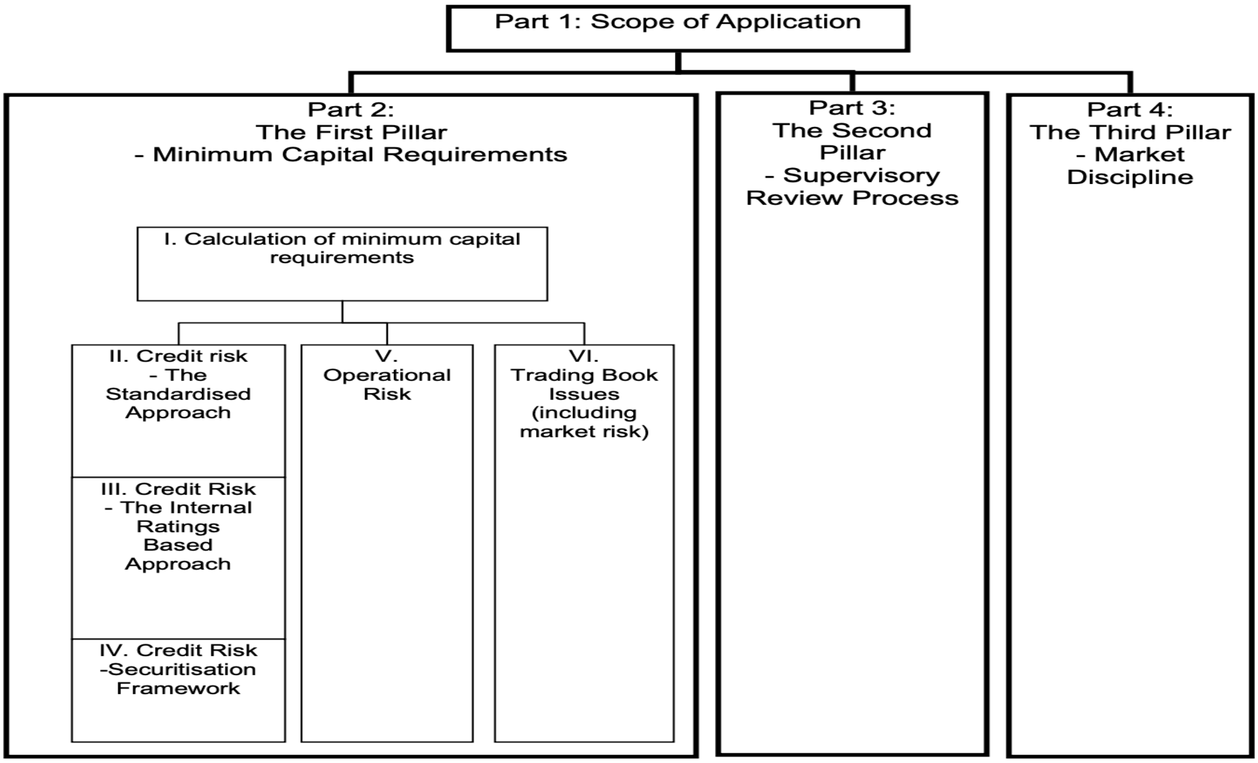

Figure 2. *Structure of the Basel II Accord.*
Source: BCBS (Jun 2004), para. 19-20.

While in its reform the BCBS retained the key elements concerning the numerator of the risk-based capital ratio as introduced by the Basel I regime, including the definition of eligible capital and the general requirement for banks to hold capital to RWAs at least equivalent to 8% (as well as the

[81] The intrinsic more complexity of Basel II compared to Basel I can be almost instantaneously noticed by comparing the length of the two documents: Basel I weighs in at 30 pages while Basel II at around 350 pages.
[82] Basel II was implemented in the EU in the form of i) Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, and ii) Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions. All EU Member States transposed the Directives into national legislation by end-2006. The application of the Basel II standards in the EU began on 1 January 2007, while the use of advanced IRB approaches for calculation of capital requirements for credit and operational risk, subject to prior supervisory approval, was enabled starting from 1 January 2008.

basic structure of the 1996 Market Risk Amendment)[83], the key regulatory objective of Basel II is to strengthen the denominator (i.e. the risk weighting of assets) by making it much more sensitive to different types and amounts of risk than the simple risk weights provided under Basel I[84]. As such, the new framework, with the aim to improve the way capital requirements reflect underlying risks and to overcome the limitations characterizing Basel I as to reliable RWAs calculations, expands the risk weight metrics and the diversification of credit risk mitigation instruments through the use of derivative financial instruments (such as credit default swaps or credit linked notes). In addition, Basel II requires banks to hold capital to cover for operational risk, i.e. the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events (including legal risk, but excluding strategic and reputational risk). In doing so, Basel II takes a more holistic approach in relation to capital measurement than the pre-existing framework, as a bank's total risk-weighted capital is to be calculated based on the weighting of every exposure under credit, market and operational risk, whose values are then to be summed up together according to a complex formula. Under this perspective, Basel II highlights that credit risk, although it is the risk that can have serious repercussions on the banking activity, is not the only important one, so that the risks of losses due to exchange rate volatility or technical and human errors should also be commensurate and adequately covered by capital[85]. Furthermore, Basel II, with a view to overcoming Basel I crude methodology to credit risk, introduces a system based on the use of external credit assessments by rating agencies for determining the creditworthiness of counterparties[86].

However, in seeking to ensure that capital charges would reflect, as best possible, business models' specific risk profiles (especially with regard to international sophisticated banks), the most significant innovation of Basel II is the greater possibility offered to banks to make use of their own internal-ratings based (**IRB**) risk management systems as inputs to capital calculations[87]. As such, Basel II offers a number of risk management approaches ranging from simpler to more advanced ones for calculating RWAs under credit risk, market risk and operational risk. In particular, under credit risk, two IRB approaches, namely the Foundation IRB approach[88] and the Advanced IRB approach[89], are

[83] See Chapter 1, Paragraph 1.3.
[84] See Dugan and Xi (2011), p. 6.
[85] See Shakdwipee and Mehta, (2017), p. 68.
[86] External credit assessments under Basel II apply to a wide range of assets. For instance, with regard to sovereign exposures, the Basel II standardised risk weight matrix, leveraging on Standard & Poor's methodology as a benchmark, provides that a credit rating corresponding to AAA to AA- would not require capital to cover for the exposure; A+ to A- would require 20%; BBB+ to BBB- would require 50%; BB+ to B- or unrated would require full coverage; below B-, capital to be held would amount to 150% (i.e. the equity capital to be held by the bank would be higher than the face value of the exposure). See BCBS (Jun 2004), para. 50 ff.
[87] When using the IRB systems to determine capital requirements, the risk components for each individual exposure that a bank needs to estimate are: i) the probability of default (**PD**), ii) the loss given default (**LGD**), iii) the exposure at default (**EAD**), and iv) effective maturity (**EM**). The PD defines the average percentage of obligors that default in a rating grade in the course of one year; the LGD indicates the percentage of exposure a bank may lose when a borrower defaults; the EAD is the outstanding nominal value a bank is exposed to when a loan defaults; the EM refers to the effective yield or interest rate of the exposure at the culmination of its tenure. See BCBS (Jun 2004), para. 211 ff.
[88] The Foundation IRB approach is a models-based credit risk calculation, with regulators supplying both the models and the assumptions to be used for inputs into the models for losses in the event of default of particular credits (LGD). See Dugan and Xi (2011), p. 6.
[89] As the most complex and sophisticated approach, the Advanced IRB approach relies on a risk model supplied by regulators, but unlike the Foundation approach, the Advanced IRB allows banks themselves to determine certain assumptions used by the model for default and other key credit risk-characteristics, including but not limited to LGD.

complemented by the BCBS supervisory-defined standardised approach (**SA**), which is based on a revised version of the simple assets' treatment model developed under Basel I[90]. Similarly, approaches for operational risk include a full range of models-based approaches, i.e. the SA, a simple Basic Indicator Approach (not expected to be used by sophisticated banks) and the IRB Advanced Measurement Approach (the Advanced IRB for credit risk and the IRB Advanced Measurement Approach for operational risk are together referred to as the '**advanced IRB approaches**')[91]. In essence, under Basel II, large and complex banks become allowed to use their own internal risk management systems to determine the risk of an asset and report this figure to their supervisors. While such BCBS proposal is sensible, as each bank is in the best position to understand the risks it is facing, a serious problem exists in implementation as banks may have the incentive not to report, in full or partially, the true risks associated to their assets. To address raising concerns that permission to choose between two broad methodologies to calculate capital requirements would create arbitrage incentives for banks to shrewdly switch from the SA to IRB approaches and vice-versa, Basel II requires that the use of alternative methodologies to the SA is subject to the authorization of the competent supervisory authority[92], and monetary penalties (or other administrative sanctions) would apply in case banks are to use IRB approaches without being duly authorised.

In relation to Pillar 2, the purpose of supervisory review is '*not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks*'[93]. Accordingly, the supervisory review process recognises the responsibility of the bank's management in developing an internal capital adequacy assessment process (**ICAAP**) to set capital targets that are commensurate with the bank's risk profile, which has then to be reviewed by the competent supervisor[94]. Specifically, the BCBS conceives the supervisory and review process as addressing three types of

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Only the largest banks the with the appropriate resources to develop and maintain up-to-date complex models can use the Advanced IRB approach to credit risk. See Dugan and Xi (2011), p. 6.

[90] It is worth mentioning that, under credit risk, Basel II lays out a separate capital requirements framework in relation to banks' exposures arising from traditional and synthetic securitisations (i.e. the so-called securitisation framework). See BCBS (Jun 2004), para. 538 ff. Similarly, a specific regime is provided under market risk for the valuation of positions in the trading book. See BCBS (Jun 2004), para. 684 ff. A bank's trading book consists of tradable positions in financial instruments and commodities held by the bank either with trading intent or in order to hedge other elements of the trading book. It represents the other side of the coin with respect to the banking book, which includes all exposures that are not actively traded by the bank and that are expected to be held until they mature (in contrast to trading book's exposures, which are booked at market value, banking book's exposures are generally accounted for at historical cost, i.e. they are not marked to market). The risk management of the banking books therefore focusses on the credit risk (probability that the bank does not recover the entirety of interests and principal), liquidity risk (maturity mismatch between assets and liabilities) and interest rate risk (sensitiveness of assets and liabilities to variations in interest rates), while for trading books risk management focusses on variations in market values, which depend on various drivers.

[91] As discussed with reference to the 1996 Market Risk Amendment to Basel I, the different risk management approaches offered under Basel II illustrate how the principle proportionality can be applied to banking regulation, as small banks with low risk profiles are allowed to make use of simpler and standardized risk models, while more sophisticated and internationally active banks are expected to adopt IRB models that are more suitable for their operations and complexity. On this argument, see A. P. Castro Carvalho et al. (2017).

[92] Retrospectively, the Basel II requirement to approve the use of certain approaches to risk measurement proved to be one of the main challenges for supervisors worldwide. While this was not a new concept for the supervisory community – as noted above, the 1996 Market Risk Amendment already involved a similar requirement – Basel II extended the scope of such approvals and demanded an even greater degree of cooperation between home and host supervisors.

[93] BCBS (Jun 2004), para. 720.

[94] This interaction is intended to foster an active dialogue between supervised banks and supervisors such that, when deficiencies are identified, prompt action can be taken to reduce risk or restore capital. See BCBS (Jun 2004), para. 722.

risk: i) risks considered under Pillar 1 that are not fully captured by the Pillar 1 process (e.g. credit concentration risk), ii) those factors not taken into account by the Pillar 1 process (e.g. interest rate risk in the banking book, business and strategic risk), and iii) factors external to the bank (e.g. business cycle effects)[95]. In order to achieve this goal, the supervisory review process sets out four principles:

Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

With regard to Pillar 3, its purpose is to encourage market discipline by developing a set of disclosure requirements that will allow market participants to assess key pieces of information on the business model, risk exposures, risk assessment processes and capital adequacy of a given credit institution[96]. In practice, the BCBS substantiates its Pillar 3 approach by outlining specific disclosure requirements relating to the ownership structure of banks, their capital base and funding markets, as well as their capital determinations and risk profile. These requirements involve regular publication of information (every six months by the domestic banks and quarterly by the internationally active banks).

The interaction between minimum capital requirements (Pillar 1), a supervisory review process (Pillar 2) and market discipline (Pillar 3) has been the way envisaged by Basel II to create an integrated and holistic supervisory model with a view to safeguarding the stability of the entire financial system. In this respect, if Basel I marked the triumph of a global capital safety net for banking intermediaries after a long period of time of vagueness in prudential rules and supervisory action, the addition of the supervisory review and market discipline pillars under Basel II robustly contributed towards a more holistic approach to banking prudential supervision and the strengthening of global financial safety nets, also as a result of the proactive dialogue between supervised entities and supervisors.

1.5. The 2007-08 global financial crisis: Is the Basel framework to blame?

While the Basel II framework was still in the process of being implemented, financial turmoil of magnitude scale, initially observed in the US and euro area interbank markets as of mid-2007,

[95] BCBS (Jun 2004), para. 724.

[96] The general principle underlying Pillar 3 is that '*[b]anks should have a formal disclosure policy approved by the board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process. In addition, banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency of them*'. See BCBS (Jun 2004), para. 821.

unfolded in mature economies and started an appalling worldwide chain reaction[97]. The long-lasting effects of the GFC, which was the most severe shock to hit the global economy since 1929 (until the recent outset of the Covid-19 pandemic[98]), have had deeply negative effects on the global economy, the fiscal position of sovereign nations and the viability of financial institutions[99]. The weaknesses in the banking sector were transmitted to the rest of the financial system and, then, to the real economy, resulting in much higher public debt, increased unemployment and substantial output losses, with almost 28 million jobs lost worldwide[100]. This held particularly true for the EU where, following five consecutive quarters of economic contraction as of the second quarter of 2008, the GFC triggered, starting from 2010, a sovereign debt crisis originating from a loss of financial markets' confidence and characterized by soaring public debt[101]. Yields on government bonds, particularly in the EU periphery countries, rose dramatically[102].

The interconnectivity of the global financial system played a key role as channel of transmission of the crisis between the US and the EU. While subprime mortgages accounted for only 3% of US financial assets, in a globalised context of highly interconnected banking markets characterised by high leverage, systemic under-pricing of credit default swaps (**CDS**)[103] and great degree of opacity on collateralised debt obligations and securitised assets[104], EU banks, which were heavily involved

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[97] A comprehensive analysis of the causes of the 2007-08 global financial crisis and the policy responses implemented by international organisations and governments worldwide is beyond the scope of this work. For a detailed discussion of the crisis, see, among others, Szczepanski (2019); BCBS (Oct 2010); Merrouche and Nier (2010); Lastra and Wood (2010); IMF (Feb 2009); Borio (2008).

[98] At the time of writing, the Covid-19 pandemic is still displaying detrimental economic effects and imposing high human, social and fiscal costs at the global level. According to first estimations, as a result of the pandemic, the global economy is projected to contract sharply by -4.9% in 2020, significantly more than during the GFC, which caused a global economic recession of around -0.1%. It has been calculated that in 2020 mature economies will see the most widespread fall in per capita income since 1870. See IMF (Jun 2020), p.1.

[99] Following the global financial meltdown in late 2008 (which reached its peak on 15 September 2008 with the bankruptcy of the investment bank *Lehman Brothers*), 91 economies representing two-thirds of global GDP in purchasing-power-parity terms experienced a decline in output in 2009. Ten years later, in 2019, the sequence of aftershocks and policy responses that followed the *Lehman* bankruptcy has led to a world economy in which the median general government debt-GDP ratio stands at 51%, up from 36% before the crisis; central bank balance sheets, particularly in advanced economies, are several multiples of the size they were before the crisis; and emerging market and developing economies now account for 60% of global GDP in purchasing-power-parity terms (compared with 44% in the decade before the crisis), reflecting in part a weak recovery in advanced economies. Data are drawn from Chen et al. (2019).

[100] After 10 years from the outbreak of the GFC, recent studies estimated that the cumulative output loss resulting from the crisis is in the order of 100% of global GDP in net present value terms. This output loss would probably have been much larger without the massive public-sector intervention measures adopted by national governments. See Ingves (2018).

[101] After being rather stable at around 60% of GDP from 2000 to 2008, the average EU government debt ratio sky-rocketed to 73% in 2009, as a result of financial crisis-related expenditure. See Szczepanski (2019), p. 3.

[102] To stabilise macro-economic imbalances and ensure the continuity of the EU and the euro area, multiple *ad hoc* fiscal safety nets and sovereigns bail-out mechanisms were urgently created between 2010 and 2012 (such as the European Financial Stabilisation Mechanism (**EFSM**) and the European Stability Mechanism (**ESM**)), later supported by the implementation of unconventional monetary measures by the ECB under Mr. Draghi's presidency.

[103] This was due to certain deficiencies of the US Commodities Futures Modernization Act 2000 and the lack of EU-wide regulations. According to BCBS data, after an almost tenfold increase in the run-up to the financial crisis, the global CDS market has shrunk virtually without interruption since 2007-08. In terms of notional amounts outstanding, the market has seen a continuous decline from peaking at roughly USD 61.2 trillion at end-2007 to roughly USD 9 trillion at end-2017. Data are drawn from Aldasoro and Ehlers, (2018).

[104] One of the first determinant of the 2007-08 global financial crisis has certainly been the evolution of banks' business models. Since the 1980s, major international banks, particularly US-based ones, gradually changed the nature of their operations from a traditional business model, where they grant loans to customers and hold them in their balance-sheet (buy and hold), to a model where loans are originated and then securitised (originate-to-distribute). While the originate-to-distribute model allowed banks to sell assets to a large number of operators that would have been otherwise held up to

in the US subprime mortgage securitisation market, quickly experienced, as much as their US peers, an acute deterioration in their capital position due to sharp repricing of credit risk (i.e. decline of portfolio values) and severe liquidity shortage. Excessive risk-taking behaviours in the run-up to the crisis were supported by the belief of many bankers that their institutions were too big to be allowed to fail, also as a consequence of the deferential and accommodating, insufficiently challenging, supervisory approach that public authorities had vis-à-vis the national banks they had to supervise. To avoid the collapse of the entire banking system, European governments and the EC were forced to take unprecedented state aid measures to bail-out the EU banking sector[105]. Starting from the case of the UK bank *Northern Rock* in September 2007[106], state aid granted to EU banks between 2007 and 2008 under the four main headings of debt guarantees, recapitalisation, liquidity support and treatment of impaired assets amounted to EUR 1.5 trillion, corresponding to around 13% of EU GDP in 2008[107]. Overall, between 2008 and 2014, state aid granted to EU banks amounted to EUR 3.89 trillion, corresponding to around 30% of EU GDP in 2013[108].

In this context of financial and economic deterioration, since mid-2007 an increasing number of policy commentators commenced to identify Basel II as one of the major causes for the GFC, highlighting some of its most controversial and, at the time of its drafting, vigorously debated standards: the inadequacy of the capital levels in the banking system, the role of rating agencies in financial regulation, the procyclicality of minimum capital requirements and the dubious assumption that banks' IRB models were better suitable to capture risk exposure than standardised models developed by supervisors. In particular, part of the commentators considered inadequate and arbitrary the 8% capital ratio as a tool to effectively absorb bank's losses under significant stress scenarios, and accused Basel II of having contributed to the undercapitalization of many banks with respect to their actual risk exposure, as Basel II rules also enabled them, through the control of data input in IRB models, to artificially meet lower capital requirements.

Even though such statements are partially correct, on the other hand it is fair to remind that, first, the objective of keeping the level of capital unchanged was thought as a pragmatic way to foster the gradual transition from Basel I to Basel II and avoid possible remarkable variations in credit supply. If the new rules had required a stronger capital base, the risk of credit rationing would have been apparent, with possible effects on the real economy. Second, imposing higher capital requirements on banks among heterogeneous financial systems in a context of growing economies and high

maturity, generating a high volume of funding and thus giving a thrust to the economy as a whole, it also favoured a high level of leverage and a reduction of the intermediaries' incentives to monitor the quality of their portfolios. See Cannata and Quagliariello (2009), p. 2.

[105] For a discussion of the emergency financing arrangements and public guarantees issued by governments and central banks worldwide following the collapse of *Lehman Brothers*, see Allen et al. (2015). The most extreme case analysed by the Authors is the one of the Irish banking crisis, which stemmed from a combination of macroeconomic imbalances, risky bank practices and unsustainable fiscal policies. As a response, emergency intervention by the Irish government included blanket guarantees for all the liabilities of the six major national banks, as well as additional measures in the form of recapitalization and purchase of defaulted assets. The guarantees on covered bonds, subordinated debt and interbank deposits amounted to a total coverage of about EUR 400 billion (about 200% of the Irish GDP). For a thorough analysis of the Irish crisis, the initially miscalibrated policy and supervisory response implemented by national authorities and the external financing arrangements entered into by the Irish government with the EC, ECB and IMF, see Baudino et al. (2020).

[106] This mortgage lending bank had a business model based on high growth, aggressive lending and real estate lending.

[107] European Commission (2009), p. 62.

[108] World Bank Group (Apr 2017), p. 19.

profitability would have proved to be politically difficult. As every compromise, this may have led to sub-optimal solutions. Finally, it is important to highlight that the Basel II framework, while stressing the role of adequate capital requirements, has also underlined the role played by banks' risk management processes in maintaining sound economic and financial conditions and addressed the issue relating to the weak incentives for banks under Basel I to develop and strengthen risk management systems. Indeed, for certain risks, robust internal controls are more effective than large capital cushions[109].

Against this backdrop, it is also worth mentioning that Basel II[110] had still to be implemented in the United States, the epicentre of global financial turmoil, when the crisis erupted[111]. While, certainly, many banks, while still meeting the Basel I capital requirements, had already reviewed their risk measurement approaches to make them consistent with the incoming Basel II discipline, it can be safely argued that the full set of prudential rules was not enforced by supervisors yet, in this way making it difficult to reach negative conclusions with regard to its effectiveness.

All things considered, while the GFC certainly disclose selected aspects of Basel II that needed fundamental review, there is ample empirical evidence in the literature converging towards the conclusion that the Basel II capital adequacy framework, even if far from perfect, cannot be seen as a major driver of the GFC[112].

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[109] For a detailed discussion of the role of Basel II as triggering factor of the GFC, see Cannata and Quagliariello (2009).

[110] Following the outbreak of the GFC, in July 2009 the BCBS, to further enhance the Basel II three supervisory pillars approach and the 1996 Market Risk Amendment, published a first regulatory response that will commonly fall under the name of 'Basel 2.5'. As a whole, the Basel 2.5 framework attempts to address some of the key causes underlying the crisis and to keep up with the financial innovations that emerged in banking markets in the run-up to the crisis. In particular, Basel 2.5 is designed to address the regulatory arbitrage problems resulting from securitisations by strengthening their treatment under Pillar 1 minimum capital requirements. Accordingly, Basel 2.5 introduces higher risk weights for re-securitisation exposures and requires banks to conduct more rigorous credit analyses of securitisation exposures rated by credit agencies (the Basel II regime on externally rated exposures will be comprehensively reviewed in the context of the Basel III reform – see Chapter 1, Paragraph II.). In addition, Basel 2.5 provides for supplemental Pillar 2 guidance to addresses weaknesses that have been revealed in banks' risk management processes, and reinforce certain Pillar 3 disclosure requirements. While the Pillar 2 guidance standards entered into force immediately, the Basel 2.5 Pillar 1 and Pillar 3 requirements were to be implemented by member jurisdictions by end-2010. However, in light of the significant regulatory flaws of the Basel prudential framework highlighted by the GFC, Basel II and Basel 2.5 will be profoundly revisited in the context of the adoption of the Basel III package in 2010. On the Basel 2.5 reform, see BCBS (Jul 2009).

[111] The US implementation of Basel II has been much slower than the domestic implementation of Basel I. The federal regulatory agencies did not adopt a final regulation applying Basel II to US banks until late 2007, and the framework did not become effective until 1 April 2010. This is opposed to the swifter implementation of Basel II by most Asian countries and the EU, which implemented Basel II with two Directives in 2006 that entered into force in 2008. On the implementation of Basel II in the United States, see Dugan and Xi (2011).

[112] Merrouche and Nier argue that overall three main factors contributed to the build-up of financial imbalances that lead to the outbreak of the crisis: i) rising global imbalances (capital flows), ii) loose monetary policy, and iii) inadequate prudential supervision and regulation. In relation to the last factor, the Authors argue, in line with the findings of the BCBS, that further regulatory harmonisation among jurisdictions with regard to the stringency of the definition of banking capital was needed. At the same time, the Authors recognise that higher capital requirements under Basel II could have affected the amount of credit extended by the banking system to the real economy, and hence potentially the build-up of financial imbalances. On the other hand, the Authors particularly stress inadequacies on the side of banking supervision, arguing that '*[t]he strongest evidence emerges in favour of the hypothesis that strong powers on the part of the supervisors to intervene in problem banks and to resolve failing financial institutions may have reduced the build-up of banking sector leverage ahead of the crisis. This evidence is consistent with the idea that strong powers in supervision and resolution can reduce moral hazard and correct risk-taking incentives that otherwise lead banks to become overexposed to aggregate credit and liquidity risks*'. See Merrouche and Nier (2010), p. 18. Similarly, Cannata and Quagliariello conclude that '*some of the 'regulatory failures' that have been highlighted (inadequate growth of banks' capital,*

II. Overview of the Basel III Framework

Following the outset of the GFC, the BCBS faced the critical task of carrying out a post-mortem exercise of the Basel II framework and diagnose what regulatory aspects needed to be urgently reformed to prevent future crises from occurring again. While the financial crisis has been primarily triggered by certain identifiable factors, such as macroeconomic imbalances, excess global liquidity and excessively loose monetary policies characterised by historically low interest rates, financial engineering and the low-quality of the core capital base of banking systems (that is, common shares and retained earnings) played a role of no secondary importance in amplifying the depth and severity of the crisis. In a report addressed to G-20 leaders, the Committee itself recognised that '*the global banking system entered the crisis with an insufficient level of high quality capital*' and that '*[b]anks were forced to rebuild their common equity base in the midst of the crisis at the point when it was most difficult to do so*'. Likewise, '*[t]he crisis also revealed the inconsistency in the definition of capital across jurisdictions and the lack of disclosure that would have enabled the market to fully assess and compare the quality of capital across jurisdictions*'[113].

To address these severe issues, the BCBS, following extensive consultations that took place since 2008 at the peak of the financial crisis, adopted between July 2009 and September 2010 a set of reforms to address some of the glaring fault-lines in the banking system exposed by the crisis, including unsustainable levels of leverage, insufficient high-quality loss-absorbing capital, excessive variability of banks' modelled RWAs and exposure to unclear risks, a mispricing of liquidity risk and inappropriate incentive structures. Such regulatory reforms, endorsed in November 2010 by the G20 leaders in Seoul and subsequently consolidated into the two BCBS documents *Basel III: A global regulatory framework for more resilient banks and banking systems*[114] and *Basel III: International framework for liquidity risk measurement, standards and monitoring*[115] dated December 2010, fall under the name of 'Basel III Accord', or 'Basel III'[116].

The Basel III Accord, with a view to strengthening financial stability across countries at the global level, lays down a new regulatory framework composed of:

- enhanced bank-level (or microprudential) regulations, which aim at raising the resilience and viability of individual banks, particularly during stress periods; and

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proliferation of off-balance-sheet exposures) and that cannot be denied are failures of Basel I, rather than of the new Framework; in other cases, they are indeed related to Basel II, but international and domestic regulators are already in the process of making important adjustments (procyclicality, role of rating agencies); finally, other issues – still significant (fair-value assessment) – have nothing to do with prudential regulation. Last but not least, we have loudly reminded something that should be plain enough, but that it is very often forgotten: the Basel II rules were not actually applied in major countries when the crisis erupted. In Europe most banks have started to apply the new rules in 2008 and in the US regulatory agencies have decided to postpone its implementation to 2010'. See Cannata and Quagliariello (2009), p. 15. Similar conclusions on the Basel II's role with respect to the outbreak of the GFC are put forth by the February 2009 de Larosière Report, which clearly states that the Basel II framework contained several improvements that would have helped mitigate the emergence of the financial crisis had they been fully applied in the preceding years. See de Larosière Report (2009), p. 16.

[113] See BCBS (Oct 2010), p. 4.

[114] See BCBS (Dec 2010a).

[115] See BCBS (Dec 2010b).

[116] On the Basel III reform package, see McNamara et al. (Nov 2014); Gortsos (2011); BCBS (Oct 2010).

- macroprudential regulations, addressing system-wide risks that can build up across the financial sector, as well as the procyclical amplification of these risks over time (systemic risk)[117].

On the one hand, Basel III microprudential reforms consist of amendments to the Accords' Pillar 1 requirements to address certain critical weaknesses of the international banking system highlighted by the crisis, namely that i) banks held an inadequate amount of capital and the capital they did hold was of an insufficient quality (capital reform), and that ii) even adequately capitalised banks experienced difficulties due to insufficient liquidity buffers (liquidity standards). On the other hand, Basel III introduces macroprudential standards to address the issue of the interconnectedness of systemically important financial institutions, which revealed to be one of the main transmission channels of macroeconomic shocks across the financial system and the broader economy (systemic risk)[118]. With its macroprudential standards, the BCBS intend for banks to become shock absorbers rather than risk transmitters during an economic downturn, volatile market conditions or a financial crisis. In this sense, Basel III, by introducing a macroprudential set of rules intended to target systemic risk, while strengthening the microprudential dimension of prudential regulation, has been appropriately defined as '*an enhanced Basel II plus a macro-prudential overlay*'[119].

In the following paragraphs the main micro- and macroprudential regulatory innovations introduced by Basel III will be discussed. In particular, while, importantly, modifying the components of the minimum capital ratio to ensure higher loss-absorbing capacity and deleverage balance sheets, Basel III introduces further requirements targeting prudential weaknesses relating to capital and risk management, notably macroeconomic capital buffers, a non-risk based leverage ratio to constrain the build-up of leverage in the banking sector[120] and a large exposure framework intended to limit, as a percentage of the bank's eligible capital, the amount of exposure a bank can have to a single counterparty (i.e. concentration risk). In particular, as regards the large exposure framework, under Basel III banks cannot have a total exposure value towards a single counterparty that is higher than 25% to their Tier 1 capital. When the total exposure value is calculated between two global systemically-important banks, this limit is reduced to 15%[121]. In addition to capital standards, Basel III introduces, for the first time at the international level, a harmonised framework on minimum

[117] A proposed definition arising from work by the IMF, FSB and BIS for the G20 defines 'systemic risk' as a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy (for these purposes, 'financial services' include credit intermediation, risk management and payment services). See CGFS (May 2010), p. 2.

[118] In particular, macroprudential policies seek to address the two dimensions of systemic risk: (a) the first is the 'time-dimension', namely the systemic risk's evolution through time. In this context, macroprudential policies seek to strengthen the resilience of the financial system at times of economic recession by limiting procyclicality, which can increase the systemic risk because of the interactions developed either within the financial system, or between the financial system and the real sector of the economy; (b) the second dimension is the 'cross-sectional dimension', namely the distribution of risk in the financial system at any given point in time. In this case, macroprudential policies aim at limiting systemic risk concentration, which could result either because of the concurrent exposure of multiple financial institutions to risks from similar exposures, or because of the interconnectedness of such institutions (and the contagion of problems amongst them), especially if they are systemically important. On the topic of macroprudential policies, see Gortsos (2011); CGFS (May 2010). For a detailed assessment of the problem relating to the contagion channels between the financial system and the real sector of the economy, see BCBS (Feb 2011).

[119] See Hannoun (2010), p. 10.

[120] For a discussion of the Basel III leverage ratio standard, see Chapter 1, Paragraph 2.2.

[121] The purpose of these limits is to ensure that banks consistently measure, aggregate and control exposures to single counterparties or to groups of connected counterparties across their books and operations so that maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency. See BCBS (Apr 2014), pp. 1-4.

liquidity ratios and monitoring tools[122], and revises Pillar 3 disclosure to enhance market discipline[123]. The final deadline to implement Basel III under national laws was 1 January 2019, even though certain prudential requirements have been phased-in starting from 1 January 2013[124]. Therefore, the Basel III framework is currently in force in all member jurisdictions and virtually worldwide[125].

2.1. The reform of Pillar 1 minimum risk-based capital

As discussed, one of the main lessons learnt from the GFC was that the international banking system entered the crisis with an insufficient level of high-quality capital and that rebuilding the common equity base in the midst of the crisis proved to be extremely difficult. Accordingly, Basel III, while making some important changes to the denominator of the risk-based capital ratio that had been the main focus of Basel II, primarily concentrate on strengthening the numerator of the risk-based ratio by improving the quality, quantity and transparency of banks' capital base. In particular, Basel III emphasis on improved capital quality revolves around a refinement of the tiered approach constituting the definition of banking capital under Basel I and carried forward by Basel II. In the view of the BCBS, the Basel III definition of regulatory capital is a 'best practice' definition that all jurisdictions should aspire to, irrespective of the risk-weighting framework they use.

Under Basel III, Tier 1 capital is intended as permanent core capital that is subordinated to all other categories of capital and creditors of the bank, and first available to absorb the losses incurred by the bank in the ordinary course of business, i.e. while the firm remains solvent and continues performing its critical functions. In such a case, the bank operates in a 'going concern' scenario. To accomplish this, the BCBS, while maintaining the overall level of capital to RWAs at 8%, calls for the majority of Tier 1 capital to be common equity ('**Common Equity Tier 1**' or '**CET1**') and restricts the types of financial instruments that can be classified as CET1 capital. By narrowing the eligibility criteria of the capital tier of highest quality, the Committee aims at ensuring highest loss-absorbency capacity and addresses Basel II's lack of precise boundaries between core Tier 1 capital and the other capital constituents, with a view, ultimately, to improving the credibility of the banks' capital base before markets and investors. This is reflected in the updated minimum capital ratio. Basel III raises the level of Tier 1 common equity from 2% to 4.5% and the overall level of Tier 1 capital to 6% – from 4% under Basel II – by introducing a new layer of core capital, i.e. the Additional Tier 1 (**AT1**).

On the other hand, under Basel III Tier 2 capital is composed by subordinated bonds whose principal amount is not perpetual (i.e. the instruments are repayable at maturity), and it is considered

[122] For an analysis of the Basel III liquidity standards, see Chapter 1, Paragraph 2.3.
[123] See BCBS (Jan 2015).
[124] See BCBS (Dec 2010a), Annex 4 for all the phase-in arrangements.
[125] Basel III was implemented in the EU in the form of i) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, and ii) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC. In the United States, Basel III rules have been incorporated into the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, H.R. 4173), collectively also known as the 'Dodd-Frank Act', which is a US federal statute that was signed into law by President Mr. Obama on 21 July 2010. The Dodd-Frank Act provided for the institutional reorganization of the US financial supervisory architecture and a first regulatory tightening on banking intermediaries following the deterioration of the US subprime mortgage markets.

‘gone concern’ capital intended to be written down or converted into equity to absorb losses only in the event of liquidation or resolution in order to protect certain categories of preferred creditors (including depositors). In order to clarify further the definition of Tier 2 capital, the BCBS removes all existing Tier 2 capital sub-categories (i.e. upper and lower Tier 2) foreseen under Basel II. In addition, Basel III abolishes the Tier 3 capital buffer for market risk[126].

In addition to enhanced transparency, consistency and quality of minimum capital requirements, Basel III introduces two macroeconomic capital buffers to ensure that banking systems have further capital layers against potential losses: i) a capital conservation buffer of CET1 equal to 2.5% of RWAs ‘*which is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred*’, and ii) a CET1 countercyclical capital buffer equal to between 0% and 2.5% of RWAs (to be determined on an ongoing basis by the national supervisory authority) intended to ‘*build up additional capital defences when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk*’[127].

With reference to the countercyclical capital buffer, the BCBS’s focus on excess aggregate credit growth implies that jurisdictions need to deploy this buffer on a periodic basis in correlation to credit cycles. In particular, national supervisors are called to monitor credit growth, the total credit-to-GDP ratio and other indicators that may signal a build-up of systemic risk, and assess whether – and to what extent – credit growth is leading to the build-up of system-wide risks. Based on this assessment, they need to put in place a countercyclical capital requirement applicable to banks established in their jurisdiction. Internationally active banks are called to calculate this buffer on the basis of a weighted average of the buffers that are being applied in the jurisdictions to which they have exposures (given that economic and credit growth cycles are not necessarily correlated across jurisdictions).

The establishment of these two additional macroeconomic capital layers is intended to fill the gap in the prudential framework with respect to the prevention of systemic risk, as Basel II did not contain any rules addressing such risk neither in terms of its time dimension nor in terms of its cross-sectional dimension[128]. As noted above[129], the Basel II capital adequacy framework, by giving the possibility to banks to rely on their own IRB systems to calculate risk-based capital, unintentionally intensified procyclicality, as it created the undesired incentive for banks, on the one hand, to stimulate further credit expansion in times of economic growth (as during such times the capital requirements imposed on them for the provision of loans were laxer), and, on the other hand, to reduce the provision of borrowed funds in times of recession (as the relevant capital requirements became stricter)[130].

The resulting Basel III minimum capital ratios are summarised as follows:

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[126] A third tier of capital (Tier 3), consisting of short-term subordinated debt and, if needed, capable of absorbing losses in the event of restructuring, was introduced by the 1996 Market Risk Amendment (see Chapter 1, Paragraph 1.3.) for the sole purpose of meeting a proportion of capital requirements for market risk. Therefore, until its repealment under Basel III, Tier 3 capital could not be computed by banks to cover for credit risk, counterparty risk or operational risk.
[127] See BCBS (Dec 2010a), pp. 54-57.
[128] For an analysis of the systemic threats posed to financial stability and the wider economy by non-bank systemically important financial institutions, particularly when they perform bank-like activities (such as maturity and/or liquidity transformation), see Busch and van Rijn (2018).
[129] See Chapter 1, Paragraph 1.5.
[130] See Gortsos (2011), p. 10.

	CET 1	Additional Tier 1	Tier 2	Total Capital
Minimum	4.5	1.5	2.0	8.0
Conservation Buffer	2.5			
Minimum plus Buffer	7.0	8.5	10.5	10.5
Countercyclical Buffer range	0 - 2.5			

Figure 3. *Capital requirements and buffers under Basel III (all number in percent to RWAs).*
Source: Author's illustration.

In addition to the revised structure of minimum capital requirements, the BCBS, to address the cross-sectional dimension of systemic risk, that is the risk of excessive interconnectedness among systemically important banks, which worked, as the collapse of *Lehman Brothers* plainly demonstrated, as a primary transmission channel of macroeconomic shocks across the financial system and economy, introduces a higher loss absorbency requirement, ranging from 1% to 3.5% CET1 to RWAs, for institutions classified as global systemically-important banks[131].

In case the capital buffers outlined above were to be partly or fully drawn down due to loss absorbency needs and should thus fall below the minimum 10.5% capital to RWAs threshold, the BCBS requires banks to rebuild them promptly by taking specific risk management measures, such as reductions of dividend payments, share buy-backs or staff bonus payments.

Last, with a view to addressing the issue of mechanistic reliance by banks on the creditworthiness assessments made by rating agencies (which revealed to be methodologically opaque and often biased by conflicts of interest), Basel III requires banks, when calculating their capital requirements to cover against credit risk and externally rated securitisation exposures, to perform their own internal assessments, irrespective of whether there is a rating by a credit rating agency, and determine whether the risk weights applied to such exposures are appropriate or not[132].

2.1.1. The Common Equity Tier 1 component

As discussed, the sequence of capital reforms enacted by the BCBS since the adoption of Basel I pursues the key objective of improving the quality of banks' capital and make them more resilient on a going concern basis in case of unexpected financial stress. In this sense, the financial components eligible to be included in a bank's regulatory capital must possess specific term and conditions, such as in relation to maturity or limits to distribution rights, as these characteristics ultimately reflect the capacity of the given financial instrument to absorb losses and restore the bank's capital position.

In this respect, the post-crisis reforms implemented by the FSB and the BCBS with regard to the resolution of banks[133] provide that losses incurred by credit institutions are imposed on capital

[131] A detailed overview of the regulatory framework applicable to global systemically-important banks is provided under Chapter 1, Paragraph 3.1.
[132] See BCBS (Dec 2010a), para. 118-121.
[133] For an overview of the global banking resolution standards, see Chapter 1, Paragraph III.

instruments and eligible liabilities in a prescribed order. In particular, standard-setters prescribe that CET1 instruments shall be the most subordinated claim either under a going concern scenario or in case of resolution. Consequently, should there be the need to restore the capital position of a bank, CET1 creditors are the first to bear losses and the last to receive any proceeds in liquidation or resolution. Thereafter, other categories of creditors of the ailing bank shall bear losses in line with the prescribed subordination mechanism, or 'cascade of claims'. To this end, financial instruments classified as CET1 must necessarily meet certain terms and conditions of high loss absorbency as specified by the BCBS[134].

According to Basel III[135], CET1 capital consists of the sum of the following elements:

1) common shares issued by the bank (or the equivalent for non-joint stock companies);
2) stock surplus (share premium) resulting from the issue of CET1 instruments[136];
3) retained earnings;
4) accumulated other comprehensive income and other disclosed reserves[137];
5) common shares issued by consolidated subsidiaries of the holding and held by third parties (i.e. minority interest); and
6) regulatory adjustments[138].

As mentioned, for the above capital elements to be included in CET1 capital, they must meet certain eligibility criteria. Basel III sets forth 14 different criteria for the classification of CET1 instruments for regulatory purposes. The main criteria are summarised in the table below[139]:

Main features of CET1 capital
1. Represents the most subordinated claim in liquidation of the bank.
2. It is directly issued and paid-in and the bank cannot directly or indirectly have funded the purchase of the instrument.
3. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.

[134] Being Tier 1 capital a bank's first line of defence against defaults, it follows that CET1 instruments, from a creditor's perspective, are the riskiest investment in a bank's capital, followed by AT1 instruments and Tier 2 capital.
[135] See BCBS (Dec 2010a), para. 52-53.
[136] That is when shares are issued at more than their 'par', or nominal, value.
[137] Reserves eligible for Tier 1 capital must be i) published (or disclosed), meaning that they have been audited, ii) post-tax, and iii) created or increased by appropriations of retained earnings or other surplus, such as share premiums, retained profit or legal reserves. As neither Basel I nor Basel III define the term 'disclosed reserves', both relying on accounting principles and national provisions, it can be assumed that disclosed reserves under the Basel I methodology would also qualify under Basel III.
[138] The term 'regulatory adjustments' generally refers to regulatory deductions – from CET1 capital, in most cases – in the calculation of capital ratios. As of 1 January 2019, Basel III provides that the full amount of certain capital items (e.g. goodwill) has to be deducted, as well as introduces limits on the recognition of certain items in capital (e.g. minority interest or reciprocal cross holdings in the capital of banking, financial and insurance entities). See BCBS (Dec 2010a), pp. 21-27.
[139] For the full list of CET1 instruments' classification criteria, see BCBS (Dec 2010a), pp. 14-15.

4. There are no circumstances under which the distributions are obligatory (non-payment is therefore not an event of default).

5. The paid in amount is recognised as equity capital for determining balance sheet insolvency.

6. The paid in amount is classified as equity under the relevant accounting standards.

7. The principal amount is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or capital reductions duly authorised by the competent authorities).

Figure 4. *Main criteria for classification of financial instruments as CET1 capital.*
Source: Author's illustration.

Importantly, perpetual non-cumulative shares (i.e. the holders of preference shares receive dividends ahead of common shareholders), while meeting the requirements for common stock under Basel I, do not meet the Basel III requirements for CET1. However, they may meet the requirements for AT1 capital.

Finally, it is worth mentioning that, while the majority of internationally active banks are established in the corporate form of joint stock companies, the aforementioned BCBS's eligibility criteria on the classification of CET1 instruments – and the same holds true for AT1 and Tier 2 instruments – also apply to non-joint stock companies, such as mutuals, cooperatives or savings institutions. The rationale for this provision is to preserve the capital quality of banking systems and ensure a level playing field by requiring that shares of non-joint stock companies are deemed fully equivalent to joint stock companies' common shares in terms of their capital quality and loss absorption capacity, so that they do not possess features that could cause a weakening of the going concern capital position of a bank during periods of market or financial stress. In a similar fashion, Basel III specifies that its capital eligibility criteria apply irrespective of whether banks' shares are held privately or publically.

2.1.2. The Additional Tier 1 component

By raising the Tier 1 minimum capital level from 4% to 6%, Basel III introduces a new core Tier 1 capital component to be summed up to the 4.5% CET1 ratio, i.e. the AT1 capital. Eligible AT1 instruments are not common equity but hybrid equity-like financial instruments, that is contingent convertible or hybrid securities that have a perpetual term and can be converted into equity when a trigger event occurs (such as CoCo bonds). Importantly, a significant difference with CET1 capital is that AT1 instruments, though being perpetual, may be redeemed at the initiative of the issuer after five years provided that prior supervisory approval is received and the bank demonstrates that, even after the capital reduction, its capital position would remain above the overall capital requirement ratio.

Under Basel III[140], AT1 capital consists of the sum of the following elements:

1) instruments issued by the bank that meet the criteria for inclusion in AT1 capital (and are not included in CET1 capital);

[140] See BCBS (Dec 2010a), p. 15.

2) stock surplus (share premium) resulting from the issue of AT1 instruments;
3) instruments issued by consolidated subsidiaries of the bank and held by third parties that are not included in CET1; and
4) regulatory adjustments.

As much as for CET1 instruments, Basel III sets forth 14 different criteria for the classification of AT1 instruments for regulatory purposes. The main criteria are summarised below[141]:

Main features of AT1 capital
1. Issued and paid-in.
2. Subordinated to depositors, general creditors and subordinated debt of the bank.
3. Neither the bank nor a related party over which the bank exercises control or significant influence (at least 20%) can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.
4. The instrument must have principal loss absorption through either i) conversion to common shares at an objective pre-specified trigger point or ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point.
5. May be callable at the initiative of the issuer only after a minimum of five years provided that prior supervisory approval is received and the bank must not do anything that creates an expectation that the call will be exercised.
6. Banks must not exercise a call unless i) they replace the called instrument with capital of the same or better quality, or ii) the bank demonstrates that its capital position is above the overall the minimum capital requirements ratio after the call option is exercised.
6. Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval.
7. Dividends/coupons must be paid out of distributable items, the bank must have full discretion at all times to cancel distributions/payments, and cancellation of discretionary payments must not be an event of default.
8. Is perpetual, i.e. there is no maturity date and there are no step-ups or other incentives to redeem.

Figure 5. *Main criteria for classification of financial instruments as AT1 capital.*
Source: Author's illustration.

2.1.3. The Tier 2 component

While Tier 1 capital is commonly known as banks' core capital, Tier 2 capital is known as banks' supplementary or contingent capital. The key difference lies in the fact that the objective of Tier 1 capital is loss absorption on a going concern basis, where the bank continues to operate in the markets and maintains its critical functions towards depositors, financial institutions and other third parties,

[141] For the full list of AT1 instruments' classification criteria, see BCBS (Dec 2010a), pp. 15-16.

whereas Tier 2 capital is considered gone concern capital and is intended to absorb losses to protect certain categories of preferred creditors (including depositors) as a result of the decision to liquidate or resolve the bank. As much as for CET1 and AT1 capital, the BCBS specifies in detail the regulatory regime applicable to Tier 2 capital components and the main characteristics such financial instruments need to have to be classified for regulatory purposes. According to Basel III, Tier 2 capital is composed of i) financial instruments issued by the bank that meet the relevant criteria set out under the framework, ii) stock surplus (or share premium) resulting from the issue of Tier 2 instruments, iii) instruments issued by consolidated subsidiaries of the bank (and held by third parties), and iv) regulatory adjustments. Importantly, in contrast to Tier 1 capital, the BCBS allows banks to classify as Tier 2 capital also loan-loss reserves (or provisions) held against future, presently unidentified losses, which are freely available to meet losses in the event they would materialise. Accordingly, provisioning ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, is excluded from the Tier 2 ratio.

The financial instruments most commonly issued as Tier 2 capital are subordinated debt instruments and convertible securities (together with, as noted, loan-loss and share premium reserves). To be classified for regulatory purposes, Tier 2 instruments need to be issued and paid-in, as well as they need to be subordinated to depositors and other preferred creditors of the issuer. However, in contrast to Tier 1 capital, Tier 2 instruments are not perpetual, i.e. they have a maturity date, which need to be at least of five years. At the same time, similarly to AT1 capital, Tier 2 instruments may be redeemed at the initiative of the issuer after five years, provided that prior supervisory approval is received and the bank demonstrates that, even after the capital reduction, its capital position would remain above the overall capital requirement ratio. Basel III sets forth nine different criteria for the classification of Tier 2 instruments for regulatory capital purposes. The main criteria are summarised below[142]:

Main features of Tier 2 capital
1. Issued and paid-in.
2. Subordinated to depositors, general creditors and subordinated debt of the bank.
3. Neither the bank nor a related party over which the bank exercises control or significant influence (at least 20%) can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.
4. A minimum original maturity of at least five years; there are no step-ups or other incentives to redeem.
5. May be callable at the initiative of the issuer only after a minimum of five years provided that prior supervisory approval is received and the bank must not do anything that creates an expectation that the call will be exercised.

[142] For the full list of Tier 2 instruments' classification criteria, see BCBS (Dec 2010a), pp. 18-19.

6. Banks must not exercise a call unless (i) they replace the called instrument with capital of the same or better quality, or (ii) the bank demonstrates that its capital position is above the overall the minimum capital requirements ratio after the call option is exercised.

7. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

Figure 6. *Main criteria for classification of financial instruments as Tier 2 capital.*
Source: Author's illustration.

2.2. The leverage ratio

As discussed, one of the most important causes of the GFC was the excessive leverage observed in the banking systems of many states, which occurred both on and off the balance sheet of a significant number of banks. Even in the case of banks characterised by robust capital adequacy ratios, leverage led to their gradual deterioration. At the peak of the crisis in 2008, financial markets and supervisory authorities exerted so much pressure on banks to reduce their leverage that this counter-productively resulted in increased losses, reduced equity capital and diminished capacity to provide loans to businesses and households. High leverage levels were, at least in part, an unforeseen result of the Basel II framework. As risk-based capital requirements' calculations necessarily involved a significant degree of complexity, with each of a bank's asset needing to be assigned a specific risk weight, credit institutions, aiming at reducing the cost from the application of the Basel II capital rules, made a non-transparent use of their own IRB approaches to determine the amount of capital they had to hold, resulting in what critics have described as an ability to 'game the system' by meeting capital requirements through overly aggressive modelling that kept RWAs artificially low[143]. In the run-up to the crisis, leverage of several banking systems raised to unsustainable levels.

Against this backdrop, to place constraints on the degree to which banks can leverage their capital base and because during the financial crisis '*[i]n many cases, banks built up excessive leverage while still showing strong risk-based capital ratios*'[144], Basel III introduces a simple, transparent, non-risk based leverage ratio that is calibrated to act as a credible supplementary measure to the risk-based capital requirements (as a 'backstop measure'). While most countries had not previously required a minimum leverage ratio in addition to risk-based capital requirements, and neither Basel I nor Basel II imposed such a requirement, the United States and Canada have unilaterally required a separate minimum leverage ratio for many years[145]. The Basel III leverage ratio complements the risk-weighted capital requirements by providing a safeguard against unsustainable levels of leverage and by mitigating modelling risks across IRB advanced measurement approaches[146]. In particular, the introduction of the leverage ratio standard reduces the scope of regulatory capital arbitrage by substituting low RWAs for high risk ones, and more generally the excessive accumulation of assets.

The leverage ratio established by Basel III is derived by dividing:

[143] See McNamara et al. (Nov 2014), p. 4; BCBS (Oct 2010).
[144] BCBS (Dec 2010a), p. 61.
[145] See Dugan and Xi (2011), p. 7.
[146] For an overview of the leverage ratio framework, see BCBS (Jan 2014).

i. as numerator, banks' Tier 1 capital (as newly defined under Basel III), and
ii. as denominator, non-risk weighted total exposures (i.e. banks' total on- and off-balance sheet exposures), based on their book value in accordance with accounting principles, subject to certain adjustments[147].

(i.e. the leverage ratio formula is (Tier 1 capital/ Total consolidated assets) ×100)

In substance, by measuring a bank's core capital (i.e. assets that can be more easily liquidated if a bank needs capital due to a crisis event) to its total assets, the leverage ratio is a reliable indicator assessing a bank's financial health. The lower the Tier 1 leverage ratio, the higher the likelihood of the bank withstanding negative shocks to its balance sheet in the event of a crisis. The minimum leverage ratio set forth under Basel III is 3%. However, the international framework leaves open the possibility to regional or national regulators to impose higher thresholds. In this sense, while risk-weighted capital requirements potentially have the greatest impact in improving banks' risk management practices, leverage constraints combined with clear requirements for higher level of equity capital would likely contribute to broader financial stability[148].

2.3. The liquidity standards

As part of Basel III, the BCBS introduced liquidity standards to the capital requirements that have historically been the cornerstone of the Basel regime[149]. This decision is very clearly a product of the nature of the GFC, which was a crisis not only of inadequate bank capital but also of inadequate bank liquidity[150]. As noted by the BCBS, '*[d]uring the early "liquidity phase" of the financial crisis that began in 2007, many banks – despite adequate capital levels – still experienced difficulties because they did not manage their liquidity in a prudent manner*'[151]. Particularly, macro-critical liquidity risks arose due to leverage and maturity mismatches, i.e. excessive funding of long-term assets with short-term liabilities[152]. With the financial crisis having illustrated the importance of ensuring that banks maintain both adequate capital and liquidity buffers, Basel III introduces, for the first time at international level, two liquidity ratios: the liquidity coverage ratio (**LCR**) and the net stable funding ratio (**NSFR**). The former is a short-term measure that evaluates whether a bank has enough liquidity

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[147] As regards the general measurement principles applying to the calculations of the leverage ratio, Basel III provides that i) on-balance sheet, non-derivative exposures are net of specific provisions and valuation adjustments (e.g. credit valuation adjustments), ii) physical or financial collateral, guarantees or credit risk mitigation purchased is not allowed to reduce on-balance sheet exposures, iii) netting of loans and deposits is not allowed. With regard to off-balance sheet exposures, these are converted into on-balance-sheet items by means of uniform credit conversion factors. In particular, commitments (including liquidity facilities), unconditionally cancellable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities are fully included in the denominator while for any commitments that are unconditionally cancellable at any time by the bank without prior notice, banks must apply a credit conversion factor of 10% to include such commitments in the leverage ratio. See BCBS (Dec 2010a), p. 62.

[148] See Lee (2014), p. 611.

[149] See Chapter 1, Paragraphs 1.3 and 1.4.

[150] Liquidity risk is the risk that a bank will not be able to pay its obligations when they become due because it is not able to liquidate assets or obtain adequate funding.

[151] BCBS (Jan 2013), p. 7.

[152] Under a business model perspective, banks generally issue liquid liabilities in the form of demandable deposits and invest mainly in illiquid assets. This maturity mismatch allows banks to improve depositors' welfare due to the sharing of liquidity risk that they provide, but also exposes them to the risk that depositors run and withdraw their funds before the maturity of the assets. On this topic, see Allen et al. (2015), p. 38.

to meet expected cash outflows during a 30-day stress scenario combined of idiosyncratic and market-wide shocks (e.g. the run-off of a proportion of retail deposits or a partial loss of unsecured wholesale funding capacity). The latter is a long-term structural measure to address funding risk that evaluates the amount of funding available from stable sources in relation to the funding needs of the bank's assets.

More in detail, the objective of the LCR is to ensure that banks have an adequate stock of unencumbered high-quality liquid assets (**HQLA**) that can be converted easily and immediately in private markets into cash to meet their liquidity needs for a 30-calendar day liquidity stress scenario, possibly caused, among other things, a three-notch downgrade in the institution's public credit rating, the run-off of a proportion of retail deposits, or a loss of unsecured wholesale funding. In this way, the LCR standard aims at improving the banking sector's ability to absorb shocks arising from sudden financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy[153]. Underlying the 30-day standard is the belief that by the 30th day of the stress scenario, bank's management and supervisors will have had an appropriate time buffer to take the necessary corrective actions, including central bank intervention as applicable, or the bank will be in the position to be liquidated or resolved in an orderly way. To calculate the overall level of funding to be held under the LCR, a bank needs to divide its stock of HQLA by the total net cash outflows expected during the 30-day stress scenario. As of 1 January 2019, the final LCR ratio to be met by banks must be equal or higher than 100%. In particular, the numerator is calculated by determining the value of the bank's unencumbered HQLA in stress conditions. The stock of HQLA can include different categories of assets specified under the Basel III framework, with the LCR calculations setting limits on and applying haircuts (i.e. discounts from the current market values) to certain types of assets. The denominator is calculated by multiplying the outstanding amounts of various types of liabilities by an excepted run-off rate designated for each liability or commitment type by the BCBS (for example, retail deposits covered by typical deposit insurance have an expected run-off rate of 5%, reflecting the belief of the BCBS that approximately 5% of such deposits will be withdrawn under a 30-day stress scenario)[154]. As the LCR standard became fully operation on 1 January 2019, as of this date onward banks shall be able to withstand significant liquidity stress up to 30 days without resorting to the sale of illiquid assets to meet liquidity demands.

In seeking to promoting a sustainable maturity structure of assets and liabilities to prevent the reoccurrence of balance sheets' mismatches and the use of short-term funding to back long-term assets and activities, Basel III introduces a second international liquidity standard, i.e. the NSFR. The NSFR evaluates a bank's liquidity position by dividing the available amount of stable funding (capital and liabilities expected to be reliable over a one-year timeframe) to its required amount of stable funding (based on the liquidity characteristics and residual maturities of the bank's assets and off-balance sheet exposures). The NSFR mandates that the ratio of available funding to required stable funding be at least 100% on an ongoing basis. Thus, the less liquid and longer term a bank's assets and exposures, the more stable funding it will need to have available to it[155].

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[153] See BCBS (Jan 2013), p. 2.
[154] See McNamara et al. (Nov 2014), p. 5.
[155] For a detailed analysis of the NSFR standard, see McNamara et al. (Nov 2014), pp. 5-7; BCBS (Oct 2014).

2.4. The principle of proportionality

As discussed, the BCBS's regulatory response to the 2007-08 financial crisis resulted in a comprehensive strengthening of the prudential framework, which goes substantially beyond the minimum capital ratios set out under Basel I and II. Since the adoption of the first Accord in July 1988, an important feature of the Basel framework was that the regulatory regime is not designed to be applied to the entirety of every national banking system. The BCBS itself sets out that its prudential framework does not follow a one-size-fits-all approach and it provides that the scope of application of its standards should cover, in principle, all internationally active banks on a consolidated basis. Accordingly, the Basel '*Core Principles for Effective Banking Supervision*'[156] do not require jurisdictions to apply the Basel III capital adequacy regime to non-internationally active banks and call for a risk-based (i.e. proportional) supervisory approach that takes into account banks' business model, their risk profiles and systemic importance. This is in line with the key objective of the BCBS to promote global financial stability and fair competition among players in international banking markets.

However, empirical evidence shows that Basel II and III have been applied by many jurisdictions to a wider set of banks. This has been due, among other things, to the fact that Basel II, in contrast to Basel I, mentioned as types of financial institutions subject to the regulatory framework not only internationally active banks, but, with reference to certain operational risk and Pillar 3 standards, also '*banks with significant operational risk exposures*'[157] and '*other significant banks (and their significant bank subsidiaries)*'[158], respectively. The adoption of Basel II, in particular, caused a significant regulatory split between the United States and Europe, as the former implemented the Basel rules slowly and only for its most sophisticated banks, while Europe implemented it for all mid-sized banks and investment firms. Indeed, according to a BIS study[159], full Basel III standards are generally enforced, as a minimum, on mid-sized to large banks, i.e. banks with balance sheets of more than EUR 20-30 billion (including within the EU), while the United States – and Brazil – stand out as significant exceptions[160].

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[156] The Basel core principles for effective banking supervision are the international benchmark and the *de facto* minimum standard for sound prudential regulation and supervision of banking systems. Issued for the first time by the Committee in 1997, they are used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to achieve a baseline level of sound supervisory practices. The BCBS core principles are also used by the IMF, in the context of Article IV consultations, and by the IMF and World Bank, in the context of Financial Sector Assessment Programmes (**FSAP**), to assess the effectiveness of countries' banking supervisory systems and practices. When first published in September 1997, the BCBS spelled out 25 core principles, which, in the Committee's view, were to ensure a banking supervisory regime's effectiveness. After several revisions, most recently in September 2012, the number of core principles for effective banking supervision has been raised to 29, covering, *inter alia*, supervisory powers, the need for early intervention and timely supervisory action, supervisory expectations of banks, and compliance with supervisory standards. See BCBS (Sep 2012).

[157] See BCBS (Jun 2004), para 647.

[158] See BCBS (Jun 2004), para. 818.

[159] See Castro Carvalho et al. (2017). This study compares the proportionality approaches in the implementation of BCBS standards in six jurisdictions: Brazil, the EU, Hong Kong SAR, Japan, Switzerland and the United States. The findings shed light on the different implementation approaches followed by these jurisdictions, both in terms of criteria and thresholds used to decide which banks are subject to a specific set of supervisory rules, as well as in terms of which banking regulatory standards are subject to a proportional implementation.

[160] In the United States, full Basel standards are applied to banking intermediaries with consolidated total assets equal to USD 250 billion. As at December 2016, 13 bank holding companies, which represent approximately 70% of total US banking assets and nearly all the relevant international exposures of the US banking sector, meet these criteria. Similarly,

In this context, the massive regulatory complexity and related compliance and reporting costs[161] deriving from the application of the Basel III rules have triggered discussions on the principle of 'proportionality', that is on how best to tailor regulatory requirements to non-internationally active banks, especially smaller and less complex ones[162]. The key feature of proportionality regimes is the criteria used to identify the banks to which a proportional framework should be applied with a view to reflecting the relative differences in risk and complexity across banks themselves and national markets. Under this perspective, it has been observed that the criteria for segmentation vary widely across BCBS jurisdictions, although usually a bank's size plays a major role. In addition to size, banks' business models and business activities are critical variables when applying a proportional (and possibly less stringent) regulatory treatment. On the other hand, any national 'proportionality strategy' should acknowledge the limits posed by other relevant policy objectives, as regulators should weigh the implications for, *inter alia*, financial stability and sound risk management practices. A proportional regulatory and reporting burden for smaller and less complex banks should not jeopardise their minimum desired solvency and liquidity ratios. In this sense, proportionality may potentially affect financial stability if not properly designed, as any reduction in regulatory costs requires simpler and less complex rules that typically entail less risk-sensitive prudential requirements. This could potentially generate incentives for unsound risk management[163].

In light of this policy trade-off, the implementation process of the Basel standards proves to be a challenging task for regulators worldwide, as in ensuring financial stability national authorities also need to take into account the potentially detrimental effects for lending rates, the velocity of circulation of money and the growth of the economy that too stringent capital ratios may have on the banking system and its profitability drivers. In this context, it is worth highlighting, as also recognised by the BCBS Chairman[164], that a proportionate implementation of the Basel framework is proving to be an intricate quandary particularly for African jurisdictions and, more generally, emerging and low-income economies. Indeed, the majority of banking sectors in African economies – South Africa aside – are far more straightforward, with activities focused on the fundamentals of loans and deposits. As the Basel accords are primarily designed for large banks in advanced economies involved in a wide variety of complex financial activities with significant cross-border operations, the application of

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the full application of Basel standards in Brazil is imposed on banks with a total exposure to GDP ratio equal or higher to 10%. See Castro Carvalho et al. (2017).

[161] For instance, the new standards for counterparty credit risk and market risk, the LCR and NSFR, and the revised Pillar 3 templates have certainly contributed to significantly increase the regulatory burden for banks. In particular, the new and more complex standards result in increased reporting requirements, as supervisors need more data to monitor the stability of individual banks and financial markets.

[162] As discussed under Chapter 1, Paragraph 1.4., the application of a proportional approach to banking regulation is not a novelty. The 1996 Market Risk Amendment and, later on in a more comprehensive way, Basel II introduced the possibility for banks to calculate capital requirements according to different risk measurement approaches based on the sophistication of their business models. In addition, Basel II introduced the Pillar 2 supervisory review process, which is a prime example of proportionality embedded into banking regulation as supervisors are called, when exercising their supervisory judgement and possibly imposing higher capital requirements or qualitative measures, to take into consideration, among other things, the size, complexity, business model and risk profiles of individual banks. Additionally, several BCBS jurisdictions have implemented specific regulatory standards for smaller and less complex banks that do not necessarily fully align with the Basel standards. For instance, Japan has established a different minimum capital ratio for non-internationally active banks, pursuant to which they are required to maintain a minimum capital ratio of 4% (instead of 8% capital to RWAs). See Castro Carvalho et al. (2017), p. 9.

[163] See Castro Carvalho et al. (2017), p. 2.

[164] Hernández de Cos (2020), p. 7.

rules on funding long-term assets with long-term capital, for example, can be difficult, given that the majority of deposits in Africa's banks are short term.

Increased difficulty in the implementation of the full Basel framework by low-income jurisdictions has been confirmed by multiple empirical studies which have stressed the main factors, beyond financial stability considerations, that drive regulators from developing countries to partially implement the Committee's banking standards in their jurisdictions[165]. First, lack of compliance with a set of global rules may harm the confidence of developed countries and their host supervisory authorities on the soundness of banks headquartered in developing countries and, more generally, local financial systems. Second, adopting international prudential standards strengthens cross-border supervisory coordination and facilitates developing countries to open up to foreign banks and build correspondent banking relationships. Third, implementation of the Basel framework generally signals sophistication to foreign investors as part of a drive to establish financial hubs in developing countries[166]. On the other hand, while acknowledging the potential benefits, it has been observed that full implementation of the Basel framework may be even more socially undesirable for poorer countries seeking to develop their economies and financial sectors. Indeed, higher capital requirements may reduce people's access to finance, which can be particularly problematic in emerging countries with less developed capital markets and greater problems of financial exclusion. In addition, the model incentivised by the BCBS, designed by a selective group of regulators on the basis of the functioning of mature economies, does not take into account many emerging countries' social and economic markets, infrastructures and priorities, in this way possibly ending up in regulatory recommendations biased towards existing problems of these countries[167].

Due to the partial unsuitability of the Basel framework for developing and low-income economies, empirical studies confirmed that regulators from such countries are typically selective adopters, choosing some components of the Basel framework while eschewing others[168]. In particular, authorities from developing countries are more likely to adopt the simpler Basel SA to credit, market and operational risk instead of the much-disputed advanced IRB measurement approaches. Similarly, simpler components of the Basel framework such as the definition of risk-based capital and the LCR

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165 A fundamental role in the growing scope of Basel II and III has been certainly played by technocratic organisations like the IMF and the World Bank. Particularly, the Asian financial crisis in 1990s marked a relevant change in the surveillance work performed by these two organisations, as that was the moment when the scope of surveillance was extended beyond monetary, balance of payments and exchange rates' issues due to the formation of international consensus that capital and banking markets' performance has important implications on financial stability. As a result, the joint IMF-World Bank FSAP was established and policy advice aiming at incentivising developing countries' regulators to engage in Basel II and III adoption is now consistently included into IMF's Article IV consultations, FSAPs and technical assistance projects. In addition, structural benchmarks (i.e. conditionality) requiring full implementation of selected Basel standards can be included by the IMF in the context of financial assistance programmes. For a recent comprehensive overview of the implementation status of Basel II and III worldwide, and the proportionality approach taken by national authorities with regard to domestic, non-internationally active banks, see Hohl et al. (2018).

166 For a critical analysis of the implementation process of Basel standards in emerging economies, with a specific focus on African jurisdictions, see Beck et al. (2018).

167 The fact that the development of the Basel standards may suffer from a biased approach as the latter would be primarily designed for mature economies is upheld by empirical evidence according to which relatively simple Pillar 1 standards such as the leverage ratio and the large exposures framework have been implemented by only 16 and 14 non-BCBS jurisdictions, respectively, out of 100 non-BCBS surveyed jurisdictions covered by a recent BIS study (see Hohl et al. (2018), p. 1). As mentioned, one of the key reasons to explain this lays in the fact that non-BCBS banks remain largely focused on traditional lending activities and do not generally rely on IRB models to calculate capital requirements, nor search for yield with high risk RWAs or are heavily exposed towards single counterparties.

168 See Hohl et al. (2018); Beck et al. (2018).

are more popular than complex requirements such as the NSFR or the macroeconomic capital buffers. From these empirical studies, it can be argued that a fully harmonised level playing field in banking markets at the global level, as supported by the IMF, World Bank and BIS, currently remains a policy objective with its own intrinsic limitations.

III. Implementing the G-20 Post-Crisis Reform Agenda: The Establishment of the Financial Stability Board

As discussed under Paragraph I., although international financial standards have a relatively long history (e.g. the BCBS *Concordat* dated 1975), in the 1990s, following major international financial crises, a significant change in their status took place. Standards that had been previously a matter of mutual agreement among a relatively narrow group of countries now became the basis for a new framework of international regulation, intended to be of global application, including to countries that are not directly involved in the formulation of such standards. To this end, in 1999, the FSF was established under the auspices of the G7 to serve the role of coordinator among global standard-setters and to promote the adoption of regulatory standards by national authorities (alongside with other multinational organisations, such as the IMF, World Bank, BIS and OECD)[169]. In particular, the FSF agreed to develop its work upon twelve key areas, including a total of fifteen standards, which will be published in the form of a compendium in April 2001. These standards were grouped into the three main categories of i) macroeconomic policy and data transparency, ii) institutional and market infrastructure, and iii) financial regulation and supervision, each encompassing several different aspects (for example, banking, securities and insurance in the context of financial regulation). The intention was that each set of key standards was to be supported by a methodology for assessment and implementation and a variety of related principles, practices and guidelines. However, while the FSF, as policy coordinator and standard-setter body enhancing financial systems' harmonisation in support of globalisation, seemed the appropriate response by the international community following the end-1990s Asian financial crisis, it has proven insufficient to address the most pervasive issues at the roots of the GFC[170].

As the crisis was as much the result of shortcomings in national regulatory systems as it was due to shortcomings in the international soft law framework, at the April 2009 London summit G-20 leaders came together amid the darkest hours of the financial crisis and resolved[171], *inter alia*, to expand the membership of the FSF to include emerging economies[172] (in line with the coincident

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[169] The establishment of the FSF was the result of the proposals included in the so-called 'Tietmeyer Report' (entitled '*International Cooperation and Coordination in the Area of Financial Market Supervision and Surveillance*'), which had been submitted to the G7 Bonn meeting of Finance Ministers and Central Bank Governors in 1999. This report was the result of the mandate, given in October 2008 in Washington D.C., to the then Governor of the *Deutsche Bundesbank*, Hans Tietmeyer, by the G7 Finance Ministers and Central Bank Governors for the submission of proposals on setting up new institutions necessary for bolstering cooperation between national supervisory authorities and international organisations and fora, in order to enhance the stability of the financial system. See Gortsos (2019), p. 60.

[170] See Arner and Taylor (2009), p. 5.

[171] The multi-pronged reform agenda launched at the 2009 summit in London set out several key policy and regulatory objectives aiming at restoring confidence in international banking and capital markets. In the following years, implementation work will be taken up, under the aegis of the FSB, by various transnational regulatory networks composed of different international organizations (as the BIS) and fora (as the BCBS). Such objectives included: i) enhanced transparency and disclosure, ii) higher capital and liquidity standards, iii) a new system of macroprudential oversight, iv) credible and effective resolution regimes for global systemically important financial institutions (**G-SIFIs**), v) a broader scope for regulation and oversight spanning all G-SIFIs, markets and instruments, vi) stronger infrastructure for key financial markets, vii) strengthened standards for centrally cleared over-the-counter (**OTC**) derivatives, and vii) measures to promote adherence to international prudential regulatory and supervisory standards.

[172] The FSB currently comprises the financial authorities (usually the central bank and/or ministry of finance, with the addition of the banking supervisory authority, where applicable) from Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Switzerland, Turkey, the United Kingdom and the United States; international organisations

membership expansions of the G-7 and the BCBS), to enhance its effectiveness as global cooperation and standard-setting mechanism by placing it under strengthened institutional grounds, as Financial Stability *Board*, and to entrust it with a broader mandate. The ultimate goal of the G-20 was to strengthen the effectiveness of financial regulation through an enhancement of the mandate, role and functions of the international institutions and committees comprising the global financial architecture. In seeking to achieve this objective, the G-20 was extensively supported by the IMF in the development of the post-crisis regulatory agenda[173]. In substance, the G-20, as political body and global driving force behind the shaping and scheduling of international financial regulation (including the Basel framework), acts through the FSB to achieve its political agenda and improve the resilience of global financial markets[174]. Currently, the FSB is one of the 9 Basel-based committees, having its main secretariat at the premises of the BIS[175]. However, it is operationally separated from the latter as it remains accountable and reports its work to its members and the G-20 Ministries, who regularly endorse the FSB policy agenda[176]. The core mandate of the FSB, as international forum at the highest level of the Basel Process[177], is to promote international financial stability by:

i. identifying and assessing the causes of systemic risks in the financial system and submitting proposals for dealing with these risks in a timely manner;
ii. coordinating the uniform implementation by international standard-setting bodies and national authorities of regulatory financial-sector standards;
iii. strengthening cross-border cooperation and information exchange among all sectoral supervisory and regulatory authorities of the financial system[178].

(the BIS, ECB, EC, IMF, OECD and World Bank); and international standard-setting bodies (the BCBS, CGFS, CPMI, IAIS, the International Accounting Standards Board (**IASB**) and IOSCO).

173 Since the outset of the 2007-08 global financial crisis, the IMF contributed to the global policy development cycle and the implementation of post-crisis regulatory reforms by i) using bilateral surveillance and financial assistance arrangements to inform post-implementation impact assessments, ii) using macroeconomic models, spillover analysis, and experience with non-FSB members to contribute to assessments of pre- and post-implementation impact, iii) using expertise on fiscal policy to help focus on its relationship with financial stability, and iv) providing technical assistance to aid in building a coherent international financial stability policy framework. See Cecchetti (2018).

174 Most recently, the importance of a timely and consistent implementation of post-crisis financial reforms has been highlighted by G-20 leaders at the 2018 Buenos Aires Summit, which reads '*[w]e remain committed to the full, timely and consistent implementation and finalization of the agreed financial reform agenda, and the evaluation of its effects*'. See G-20 Leaders' Declaration, Buenos Aires Summit, 1 December 2018, Section 25.

175 See Chapter 1, Paragraph 1.1.

176 According to Article 7 of the FSB Charter, adopted in June 2012, the FSB's organizational structure comprises: i) the Plenary, as the sole decision-making body, ii) a Steering Committee to take forward operational work in between plenary meetings, iii) three Standing Committees (about which, see ft. 178), iv) working groups, v) regional consultative groups, which represent large regions of the globe (roughly on a continental basis) and provide interaction by FSB members with non-members regarding the various FSB initiatives, vi) the Chair, who represents the FSB externally and chairs the meetings of the Plenary and of the Steering Committee, and (vii) a Secretariat.

177 See Figure No 1 in Chapter 1, Paragraph 1.1.

178 According to Article 2 of the FSB Charter, the FSB is, more specifically, mandated to: i) assess vulnerabilities affecting the global financial system as well as to identify and review, on a timely and ongoing basis within a macroprudential perspective, the regulatory, supervisory and related actions needed to address these vulnerabilities and their outcomes, ii) promote coordination and information exchange among authorities responsible for financial stability, iii) monitor and advise on market developments and their implications for regulatory policy, iv) monitor and advise on best practice in meeting regulatory standards, v) undertake joint strategic reviews of the international standard-setting bodies and coordinate their respective policy development work to ensure this work is timely, coordinated, focused on priorities and addresses gaps, vi) set guidelines for establishing and supporting supervisory colleges, vii) support contingency planning for cross-border crisis management, particularly with regard to systemically important firms, viii) collaborate with the IMF to conduct 'early warning exercises', ix) promote member jurisdictions' implementation of agreed commitments, standards and policy recommendations, through monitoring of implementation, peer review and disclosure.

In particular, in accordance with the grouping of standards under three broad policy areas as developed by the FSF, the FSB supports the implementation by national authorities of 15 key international standards and codes of good practice, which are the key components of the FSB compendium and represent the basis of internationally agreed minimum financial regulation. These are, in the area of macroeconomic policy and transparency, the i) IMF fiscal transparency code, which identifies a set of principles to help governments provide a clear picture of their structure and finances, ii) IMF enhanced general data dissemination system, which fosters sound statistical practices with respect to economic, financial and socio-demographic statistics, iii) IMF code of good practices on transparency in monetary and financial policies, which identifies desirable transparency practices for central banks in their conduct of monetary and financial policies, and iv) the IMF special data dissemination standard, which serves to guide countries in the dissemination of economic and financial capital markets-related data to the public. In the area of financial regulation and supervision, the FSB supports the implementation of the i) IAIS and IOSCO core principles and standards, ii) core principles for Islamic finance set by the Islamic Financial Services Board (**IFSB**)[179], and iii) the BCBS core principles for effective banking supervision[180]. In the area of institutional and market infrastructure, the FSB supports the implementation of the i) international standards on auditing developed by the International Auditing and Assurance Standards Board (**IAASB**)[181], which serve as a global benchmark on the independent auditors' responsibilities when conducting an audit of financial statements, ii) OECD principles of corporate governance, iii) IADI core principles for effective deposit insurance systems, which serve as a benchmark for jurisdictions to assess the quality of their deposit insurance systems, iv) FSB key attributes of effective resolution regimes for financial institutions[182], v) CPMI/IOSCO principles for financial market infrastructures, vi) FATF 40 Recommendations and 11 Outcomes on AML/CFT, vii) World Bank's insolvency and creditor rights standard, which is an assessment tool to assist countries in their efforts to improve insolvency and creditor regimes, and viii) the international financial reporting standards set by the IFRS Foundation, which represent the global framework in the field of accounting.

In addition to fostering a globalised level playing field by supporting the coherent implementation of the largest part of international financial soft-law across multiple sectors and jurisdictions, the FSB sets minimum standards in the area of banking resolution, which FSB members commit to implement at the national level. As much as BCBS, the FSB is not a treaty-based organisation and lacks legal personality. Thus, its soft law standards do not (formally) give rise to binding legal obligations, as G-20 leaders have not demonstrated yet to be prepared to surrender, to any significant degree, sovereignty over financial regulatory production through the conclusion of an international treaty[183]. In this respect, FSB members, in addition to pursuing the maintenance of international financial stability, maintaining the openness and transparency of their financial sectors and implementing

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[179] The IFSB is an international standard-setting body established in 2002 and currently located in Kuala Lumpur that is responsible for promoting and enhancing the soundness of Islamic banking markets by issuing global prudential standards and guiding principles for the industry. In light of the specificities of Islamic banking activities and products, the IFSB principles complement the existing global supervisory framework (principally, the BCBS core principles for effective banking supervision).
[180] See Chapter 1, Paragraph 2.4.
[181] The IAASB is an independent global standard-setting body established 1978 and currently located in New York that is tasked with setting international standards for auditing, quality control, review and related services.
[182] For an in depth-analysis of the FSB's key attributes for the effective resolution of banks, see Chapter 1, Paragraph 3.2.
[183] See IMF (2012), p. 7.

financial standards (including the FSB compendium), commit to undergo periodic peer reviews carried out by FSB staff (similarly to what the BCBS achieves through the RCAPs[184]). Peer reviews, conducted by the Standing Committee on Standards Implementation (**SCSI**)[185], are focused on the full, timely and consistent implementation of financial standards and policies agreed within the G-20/FSB and are a means of fostering a 'race to the top' in terms of adherence to standards. There are two types of peer reviews: thematic reviews and country reviews. Thematic reviews focus horizontally on the implementation and effectiveness of a selected number of international financial standards developed by global standard-setters across the FSB membership[186]. Country reviews focus on the implementation and effectiveness of regulatory and supervisory policies in a selected FSB jurisdiction. Such reviews examine the steps taken by national authorities to address IMF-World Bank FSAPs and Reports on the Observance of Standards and Codes' (**ROSCs**)[187] recommendations that are deemed most important to the FSB's core mandate of promoting financial stability[188].

3.1. The framework applicable to global systemically important banks

As discussed, the impairment of a number of large, globally active financial institutions during the GFC sent shocks through the financial system, jeopardising the real economy. Basel III macroprudential rules to tackle systemic risk were not in place yet. Macro- and microprudential supervisory authorities had limited options to prevent problems affecting individual banks from spreading and thereby undermining financial stability. As a consequence, public sector intervention to restore financial stability was conducted on a massive scale and taxpayers-funded bailouts became a defining characteristic of the crisis[189]. Both the financial and economic costs of these interventions

[184] See Chapter 1, Paragraph 1.2.

[185] Together with the Standing Committee on Assessment of Vulnerabilities (**SCAV**), which is the FSB main mechanism for identifying and assessing risks in the financial system, and the Standing Committee on Supervisory and Regulatory Cooperation (**SRC**), which is charged with undertaking supervisory analysis or framing a regulatory or supervisory policy response to a material vulnerability identified by SCAV, the SCSI, responsible for monitoring the implementation of agreed FSB policy initiatives and international standards, is one of the three main standing committees of the FSB. Each of the three FSB standing committees has specific, but complementary, responsibilities in the key work areas mandated to the FSB.

[186] The main objective of peer reviews is to encourage full, timely and consistent cross-country and cross-sector implementation of standards and to identify gaps and weaknesses in reviewed areas with the aim to making recommendations for potential follow-up (including via the development of new standards). See FSB (Apr 2017).

[187] Launched by the IMF, as much as the FSAP, following the South-Asian crisis in the late 1990s, ROSCs summarize the extent to which countries observe certain internationally recognized standards and they are prepared and published at the request of the individual IMF (and, hence, World Bank) member country. The IMF has recognized 12 areas and associated standards as useful for the operational work of the Fund and the World Bank. These comprise accounting; auditing; AML/CFT; banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation. ROSCs are used to bolster IMF-World Bank's policy discussions with national authorities, and in the private sector (including by rating agencies) for risk assessments. Short updates are produced regularly and new reports for every of the 190-member countries (with the newest member, Andorra, joining the IMF and World Bank in October 2020) are generally produced every few years.

[188] In its last report to G-20 leaders on the implementation and effects of the post-crisis financial regulatory reforms, the FSB notes that, despite the progress made, significant evidence indicates that the implementation of the reforms is not yet complete and is unevenly distributed across regulatory areas and jurisdictions. In particular, the FSB recommends to complete policy work with regard to the insurance sector and the operationalisation of resolution regimes for central counterparties, as well as in relation to the implementation of Basel IV (on the latter, see Chapter 1, Paragraph IV). See FSB (Oct 2019).

[189] See Chapter 1, Paragraph 1.5. for the total amount of funds injected into the European banking markets by EU governments, following state aid approval by the EC. In the United States, starting from the approval on 3 October 2008 by President Mr. Bush of the $700 billion Emergency Economic Stabilization Act that established the Troubled Assets

and the associated increase in moral hazard[190] implied that additional prudential measures had to be put in place to reduce the likelihood and severity of problems that emanate from the failure of G-SIFIs, and, particularly, global systemically important banks (**G-SIBs**).

The rationale for adopting additional regulatory measures for G-SIBs is based on the cross-border negative externalities created by systemically important banks, which pre-crisis regulations did not effectively address. While the negative externalities associated with institutions that are perceived to be too important to be allowed to fail due to their size, interconnectedness, complexity, lack of substitutability and/or global scope are well recognised, individual financial institutions, in maximising their private benefits, may rationally choose outcomes that, on a system-wide level, are suboptimal because they do not take into account these externalities[191]. Moreover, the moral hazard costs associated with implicit guarantees derived from the perceived expectation of government support may amplify risk-taking, erode market discipline and create competitive distortions, increasing further the probability of future financial distress[192]. As a result, the costs associated with moral hazard can compound any direct costs of support that may be borne by taxpayers. While government guarantees can be effective tools when used as *ad hoc* temporary measures to prevent the occurrence of panic-based crises, 'too-big-to-fail' banks, if not regulated, may continue to not internalise the social costs of their operations while engaging in excessive risk-taking behaviours and inappropriate incentive and remuneration structures[193].

Relief Program (**TARP**), it has been calculated that public financial support under the categories of debt guarantees, recapitalisation and liquidity support to banks amounted overall to around USD 12.8 trillion.

[190] Moral hazard occurs when an agent increases risk without facing the full consequences, which in part or in full will be borne by another agent, such as a government bailing out the creditors of a failed bank. For this definition, see IMF (2020), p. 11.

[191] As the IMF clearly stated a couple of years after the outbreak of the global financial crisis, '*[w]hile we should strive for regulation that provides incentives for private institutions, wherever possible, to take actions that reinforce financial stability, we should recognize that system-wide stability is a public good that will be undervalued by private institutions and regulations will need to force systemically important firms to better internalize the overall societal costs of instability. For this to occur, the mandates of central banks, regulators, and supervisors should include financial stability. A clear framework to assess and act upon systemic risks will need to be in place, with a clear delineation of who is the lead systemic regulator*'. See IMF (Jun 2009), p. xxii.

[192] For a comprehensive critical analysis of economic and legal literature on moral hazard in banking operations and the pros and cons of government guarantees in the banking industry, see Allen et al. (2015).

[193] One of the prime examples of the application of the 'too-big-to-fail' doctrine and the problem of externalities has been the insolvency of the US insurance company *American International Group* (**AIG**). To avoid economic disruption of magnitude scale comparable to *Lehman Brothers*' failure, AIG was spared from bankruptcy during the global financial crisis as the US government actively intervened by injecting into its capital base around USD 180 millions of emergency funding through the TARP. In the 2008-mid September decisive meeting to decide whether to bail-out AIG, Mr. Bernanke, the former Chair of the Federal Reserve System (**FED**), grimly '*spelled out what would happen if AIG failed*' and that it would '*be felt across America and around the world*', leaving him with no choice but authorising emergency assistance. AIG's bail-out became unavoidable due to a mix of lax regulations and institutional supervisory flaws at the US federal level. To purportedly avoid stiffer regulation, AIG was strategically set up, and thus regulated, as a Thrift Holding Company because it owned a savings and loan subsidiary (i.e. a thrift), which under US financial regulation is not subject to fully-fledged prudential supervision and regulation by the FED like banks (thrifts are financial entities similar to mutual savings banks or credit unions in continental Europe). The functional misallocation of responsibilities under the US supervisory system allowed AIG (the parent company) to be regulated by the Office of Thrift Supervision (dissolved in October 2011 by the Dodd-Frank Act and subsequently merged into the FDIC), while AIG Financial Products Corp. (the subsidiary) was regulated by another supervisor, the Securities and Exchange Commission (**SEC**). However, due to at the time existing regulations, the SEC was only responsible for regulating AIG's business unit that dealt with securities and not the CDSs traded by the subsidiary. As well-known, those derivative products will reveal to be the culprit that ultimately caused AIG's near bankruptcy and later found to be one of the root causes of systemic risk

In order to address the problem of externalities posed by G-SIBs, and hence reduce systemic risk, international standard-setters resolved to, on the one hand, reduce G-SIBs' probability of failure by increasing their going-concern loss absorbency[194], and, on the other, mitigate the scale and impact of G-SIBs' failures by improving global recovery and resolution frameworks[195] (this set of reforms is usually referred to as the 'G-SIB framework'). These objectives have been addressed by the BCBS and the FSB, respectively. In particular, as internationally active banks tended to increase their size, scale and interconnectedness under the assumption that ultimately they could be saved by public emergency funding if and when a crisis occurred, in October 2010 the FSB, with the aim to incentivise banks to shrink their systemically important activities and discourage excessive concentration, mandated the BCBS to develop a methodology to calculate a bank's contribution to overall systemic risk – in other words, a bank's systemic importance[196]. In the FSB and BCBS' views, the higher the systemically importance of a bank, the higher the level of capital it should be required to hold. In line with the FSB's recommendations, the BCBS developed its methodology to assess the systemic importance of a bank in 2011 by including both quantitative and qualitative indicators, as well as Pillar 1 and Pillar 2 elements[197]. In particular, the BCBS methodology provides that '*global systemic importance should be measured in terms of the expected impact that a bank's failure can have on the global financial system and wider economy, rather than the risk that a failure could occur*'[198]. The BCBS approach combines a global, system-wide, LGD concept with a PD concept, where a higher measured LGD is offset with a lower PD using capital surcharges. Accordingly, the G-SIBs methodology relies on an indicator-based measurement approach, under which the indicators are chosen to reflect the different factors that generate negative externalities, in this way making a bank significant for the stability of the financial system. In particular, the five selected systemic importance indicators[199] reflect i) the size of a bank[200], ii) its interconnectedness[201], iii) the lack of readily available substitutes or financial institution infrastructure for the services it provides[202], iv) its global

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and financial contagion at the global level between 2007 and 2009. On AIG's bankruptcy and the systemic consequences, see Lee (2014), p. 608 ff.

[194] For an overview of the newly introduced Basel III minimum capital requirements and buffers, see Chapter 1, Paragraph II. In addition, in November 2015 the FSB will introduce, as requirement applicable only to G-SIBs, as an additional buffer of convertible liability that would sit on top Basel capital requirement.

[195] See Chapter 1, Paragraph 3.2. for a discussion of the post-crisis international resolution standards for banks.

[196] See FSB (2010), Annex 1.

[197] The BCBS's G-SIBs methodology is in force as revised in July 2018. As the BCBS committed to review its framework every three years, the G-SIBs methodology will be re-discussed, and possibly amended, by end-2021.

[198] See BCBS (Jul 2018), para. 14.

[199] See BCBS (Jul 2018), para. 21 ff.

[200] A bank's distress or failure is more likely to damage the global economy or financial markets if its activities comprise a large share of global activity. The larger the bank, the more difficult it is for its activities to be quickly replaced by other banks and therefore the greater the chance that its distress or failure would cause disruption to the financial markets in which it operates. The distress or failure of a large bank is also more likely to damage confidence in the financial system as a whole. Size is therefore a key measure of systemic importance. The indicator commonly used to measure size is the total exposures denominator of the leverage ratio (see Chapter 1, Paragraph 2.2.).

[201] Financial distress at one institution can materially increase the likelihood of distress at other institutions, given the network of contractual obligations in which these firms operate. A bank's systemic impact is likely to be positively related to its interconnectedness vis-à-vis other financial institutions. Three indicators are used to measure interconnectedness: i) intra-financial system assets, ii) intra-financial system liabilities and iii) securities outstanding.

[202] The systemic impact of a bank's distress or failure is expected to be negatively related to its degree of substitutability as both a market participant and client service provider, i.e. it is expected to be positively related to the extent to which the bank provides financial institution infrastructure. For example, the greater a bank's role in a particular business line, or as a service provider in underlying market infrastructure (e.g. payment systems), the larger the probable disruption following its failure, in terms of both service gaps and reduced flow of market and infrastructure liquidity. At the same

(cross-jurisdictional) activity[203], and v) its complexity[204]. In calculating the systemic importance of a bank, each of the five categories has an equal weight of 20%. The BCBS indicator-based measurement approach is based on a large sample of banks as its proxy to calculate the score of a given G-SIB[205]. Banks with a score produced by the G-SIB methodology that exceeds a cut-off level (currently 130 bp) are classified as G-SIBs. Subject to certain principles and criteria, supervisory judgment may also be used to add banks with scores below the cut-off to the list of G-SIBs[206].

The BCBS, in cooperation with national authorities, runs its systemic importance assessment on an annual basis and recommends its classification to the FSB, which is the body ultimately responsible for adopting the G-SIB list[207]. G-SIBs are allocated into equally sized buckets[208], based on their scores of systemic importance, with varying levels of higher loss absorbency capital requirements applied to the different buckets. As at November 2020, there are 30 G-SIBs worldwide[209]. In particular, out of the five buckets currently comprising the FSB G-SIB list, bucket 1 requires a G-SIB to hold 1.0% of additional capital to RWAs[210], bucket 2 additional 1.5%[211], bucket 3 additional 2.0%[212], bucket 4 additional 2.5%[213], bucket 5 additional 3.5%[214]. The FSB/BCBS additional capital buffer sits on top of the combined capital buffers and minimum capital

time, the cost to the failed bank's customers in having to seek the same service from another institution is likely to be higher for a failed bank with relatively greater market share in providing the service. Three indicators are used to measure substitutability/financial institution infrastructure: i) assets under custody, ii) payments activity and iii) underwritten transactions in debt and equity markets.

[203] Given the focus on G-SIBs, the objective of this indicator is to capture banks' global footprint. Two indicators in this category measure the importance of the bank's activities outside its home (headquarter) jurisdiction: i) cross jurisdictional claims and ii) cross-jurisdictional liabilities. The idea is that the international impact of a bank's distress or failure would vary in line with its share of cross-jurisdictional assets and liabilities. The greater a bank's global reach, the more difficult it is to coordinate its resolution and the more widespread the spillover effects from its failure.

[204] The systemic impact of a bank's distress or failure is expected to be positively related to its overall complexity, i.e. its business, structural and operational complexity. The more complex a bank is, the greater are the costs and time needed to resolve the bank. Three indicators are used to measure complexity: i) notional amount of OTC derivatives, ii) Level 3 assets, and iii) trading and available-for-sale securities.

[205] The score for each indicator is calculated by dividing the individual bank amount at consolidated level (expressed in EUR) by the aggregate amount for that indicator summed across all banks in the sample. This amount is then multiplied by 10,000 to express the indicator score in terms of basis points (**bp**).

[206] See BCBS (Jul 2018), para. 30 ff.

[207] The G-SIBs list update is usually published during the month of November each year. In addition to the list of G-SIBs, the FSB, in November 2014, 2015 and 2016, published the list of global systemically important insurers, based on recommendations from the IAIS. However, as since 2017 the IAIS commenced to develop a holistic framework for the assessment and mitigation of systemic risk in the insurance sector at the global level, which has been ultimately published in November 2019, the FSB has decided to suspend its identification of global systemically important insurers starting from 2020. Systemically important insurers are expected to comply with the IAIS standards on higher loss absorbency.

[208] The current bucket size is set at 100 bp. See BCBS (Jul 2018), para. 46.

[209] See FSB (Nov 2020).

[210] At present, the banks falling into the bucket 1 are: *Agricultural Bank of China*, *Bank of New York Mellon*, *Credit Suisse, Goldman Sachs*, *Groupe BPCE*, *Groupe Crédit Agricole*, *ING Bank*, *Mizuho FG*, *Morgan Stanley*, *Royal Bank of Canada*, *Santander*, *Société Générale*, *Standard Chartered*, *State Street*, *Sumitomo Mitsui FG*, *Toronto Dominion*, *UBS*, *UniCredit* and *Wells Fargo*.

[211] At present, the banks falling into the bucket 2 are: *Bank of America*, *Bank of China*, *Barclays*, *BNP Paribas*, *China Construction Bank*, *Deutsche Bank*, *Industrial and Commercial Bank of China* and *Mitsubishi UFJ FG*.

[212] At present, the three banks falling into bucket 3 are: *Citigroup*, *HSBC* and *JP Morgan Chase*.

[213] As of November 2020, this bucket is empty. In the 2019 list, bucket 4 was populated by only one bank, i.e. *JP Morgan Chase*.

[214] The fifth – currently empty – bucket on top of the highest populated bucket aims to provide incentives for banks to avoid becoming more systemically important. If a bank's score increases such that it exceeds the top threshold of the fourth bucket, a new sixth empty bucket will be added with an even higher additional loss absorbency level applied to provide further incentives for G-SIBs to reduce their systemic importance and activities. See BCBS (Jul 2018), p. 7.

requirements[215], and it is normally implemented by national supervisors through an extension of the capital conservation buffer, or through a specific G-SIBs buffer. G-SIBs are required to meet the FSB/BCBS capital surcharge with CET1 capital only[216]. If a G-SIB breaches its additional capital requirement, it is required to agree a capital remediation plan to return to compliance over a time frame established by the relevant supervisory authority. Until it returned to compliance, the G-SIB is subject to the limitations on dividend pay-outs (and other possible arrangements as required by its supervisor)[217]. It should be noted that, since the adoption of the first version of the BCBS methodology in 2011, the number of G-SIBs, and their bucket allocation, evolved over time as banks changed their risk-taking behaviours in response to the incentives of the G-SIB framework (as well as other aspects of Basel III and country-specific regulations). Indeed, a recent BIS study[218] provides evidence that, since the adoption of the G-SIB framework, most G-SIBs have reduced their G-SIB scores and shrunk their balance sheets, while, in contrast, non-G-SIBs have increased their relative G-SIB scores during the same period. In addition, the regional analysis indicated that trends in banks' G-SIB indicators, and the indicators that contribute most to the final G-SIB score, are heterogeneous across countries and regions. While G-SIBs from the euro area, Great Britain and the United States have reduced their systemic importance for most indicators since 2011, Chinese and Japanese G-SIBs have shown relatively positive growth rates for all indicators, and particularly high ones for indicators in the substitutability category.

3.2. The Key Attributes for the effective resolution of financial institutions

The G-SIB framework forms part of a broader effort by the international community, under the aegis of the G20/FSB and the International Monetary and Financial Committee (**IMFC**)[219], to reduce the moral hazard of 'too-big-to-fail' G-SIFIs and their competitive advantages in funding markets, and to allow national authorities to resolve financial institutions in an orderly manner without either exposing public funds to loss or endangering financial stability. Such framework is based on a two-pronged strategy, as it comprises higher going-concern loss absorbency requirements as determined by the BCBS and endorsed by the FSB[220], as well as an enhanced recovery and resolution regime

[215] See Chapter 1, Paragraph III.
[216] The capital buffer requirement for the G-SIBs identified in the annual update each November apply to them as from January fourteen months later. For instance, the assignment of G-SIBs to the buckets in the 2020 November list determines the higher capital buffer requirement that will apply to each G-SIB from 1 January 2022.
[217] If a G-SIB progresses to a bucket requiring a higher capital loss-absorbency requirement, it is required to raise additional capital or shrink exposures within a time frame of 12 months. After this grace period, if the G-SIB does not meet the FSB/BCBS capital surcharge, the capital retention mechanism for the expanded capital conservation buffer applies. If, on the other hand, the G-SIB score falls, resulting in a lower capital requirement, the bank is immediately released from its previous capital requirement (unless the supervisor requires the G-SIB to delay the release of the capital surcharge). See BCBS (Jul 2018), para. 55-57.
[218] See BCBS (Feb 2019).
[219] As an internal specialised committee of the IMF, the IMFC advises and reports to the IMF Board of Governors on the supervision and management of the international monetary and financial system, including on responses to unfolding events that may disrupt the system. It also considers proposals by the IMF Executive Board to amend the IMF Articles of Agreement. Although the IMFC has no formal decision-making powers, in practice, it has become a key instrument for providing strategic direction to the work and policies of the IMF. The size and the composition of the IMFC mirrors that of the IMF Executive Board. Since January 2021, the group is chaired by Ms Andersson, Sweden's Minister for Finance, and usually meets twice a year. The IMFC operates by consensus, including on the selection of its chairman.
[220] See Chapter 1, Paragraph 3.1.

aiming at mitigating the scale and impact of G-SIBs' cross-border failures[221]. To achieve the latter objective, in October 2011, the FSB published the Key Attributes of Effective Resolution Regimes for Financial Institutions (the '**Key Attributes**')[222], which lay out the core elements that a resolution regime should incorporate to allow designated national authorities to orderly resolve any type of financial institution, which would be systemic in failure, while maintaining continuity of its vital economic functions[223]. To this end, the FSB objective is to provide national resolution authorities with a broad range of powers to resolve failed or failing banks and, what is more relevant in multinational banking groups, to facilitate a coordinated resolution approach across multiple countries[224].

The FSB global framework comprises 12 Key Attributes considered essential for an effective resolution regime to secure uninterrupted provision of critical banking services and minimise depositors' uncertainty that could result in a loss of confidence. While such standards apply in principle to any type of financial institution that could be systemic in the event of failure, two Key Attributes, relating to cross-border crisis management groups, apply only to G-SIFIs[225]. The other Key Attributes apply to resolution regimes for all financial institutions (including banks)[226]. The framework described by the Key Attributes requires that, as a bank nears the point of non-viability, a resolvability assessment would determine whether its failure could be macrocritical, or systemically significant. In this case, the bank would need to be resolved pursuant to the FSB resolution standards. Alternatively, the bank would need to be orderly wound-down, or liquidated, according to national insolvency rules. Therefore, the FSB resolution framework applies in principle only to those financial

[221] Resolution differs fundamentally from standard bankruptcy and insolvency processes. Bankruptcy is a court-administered process that is focused on legal entities. It works for individual companies, but it is messy and disruptive if applied to complex group structures with hundreds of financially and operationally interconnected entities located in multiple jurisdictions. Resolution is controlled by administrative rather than judicial authorities. It also pays greater heed to the systemic consequences of financial failure by seeking to ensure that critical functions continue to be performed by a recapitalised institution, a newly established bridge institution, or otherwise by market participants. See Hüpkes (2015).

[222] The FSB adopted the Key Attributes at its Plenary meeting in October 2011. The G20 Heads of States and Government subsequently endorsed the Key Attributes at the Cannes Summit in November 2011 as '*new international standards for resolution regimes*'. See G-20 Leaders' Declaration, Cannes Summit, 3-4 November 2011, Section 13. On 15 October 2014, the FSB adopted additional guidance that elaborates on the application of the Key Attributes to insurers, financial market infrastructures and the protection of client assets in resolution. As such, the current version of the Key Attributes is in force as updated in October 2014.

[223] Resolution of financial institutions should be carried out by administrative resolution authorities with clear statutory objectives that include the pursuit of financial stability and continuity of financial institutions' critical functions. The resolution regime should enable the authority to intervene when the ailing firm is (or likely to be) no longer viable, with no reasonable prospect of return to viability. This means before it is balance sheet insolvent. See FSB (Oct 2014).

[224] The rapid growth of cross-border banking and the 2007-08 global financial crisis proved that the resolution process for global banking groups was, in most cases, cumbersome as institution-specific cooperation arrangements were not established and, as a consequence, resolvability assessments and resolution strategies were not enforced in a coordinated manner by all relevant stakeholders in the different jurisdictions. For these reasons, following the crisis a broad consensus emerged at the international level to develop a regulatory framework that would enable resolution authorities from different jurisdictions to resolve cross-border multinational banking groups in a quick and effective manner (over a weekend, theoretically), avoiding negative spill-over effects to the rest of the financial system. See BBVA (2014).

[225] These are the Key Attributes No 8 and 9.

[226] However, some Key Attributes require adaptation and sector-specific interpretation. In 2014, the 12 'umbrella' standards have therefore been supplemented with Annexes providing implementation guidance for insurers, financial market infrastructure and firms that hold client assets. The FSB has also developed further guidance on resolution strategies and planning for different types of financial institutions (including banks).

institutions that pose a systemic threat to financial stability in the event of bankruptcy[227]. Ultimately, the FSB 12 Key Attributes refer to four principal elements: i) strengthened national resolution regimes and powers (including bail-in mechanisms), ii) arrangements for international cooperation and resolution of cross-border groups, iii) improved recovery and resolution planning[228], and iv) legal safeguards for creditors. A summary of the FSB Key Attributes is provided in the table below:

The *Key Attributes* set out 12 features considered essential for an effective resolution regime:

- ***Scope:*** The regime should cover any financial institution that could be systemically significant.
- ***Resolution authorities:*** Should be independent and have clear mandates, roles, and responsibilities.
- ***Toolkit:*** Resolution authorities should have broad resolution powers, including powers to intervene quickly (prior to insolvency) and implement the resolution strategy.
- ***Set-off, netting, collateralization, segregation of client assets:*** These arrangements should be preserved, although the authorities should also be able to suspend their operation, subject to adequate safeguards.
- ***Legal Safeguards:*** While resolution authorities may depart from the hierarchy of claims, they may have to offer compensation to creditors, and their decisions must be subject to judicial review.
- ***Funding of firms in resolution:*** Authorities should minimize the use of public funds to resolve firms and resort to privately financed sources of resolution funding.
- ***Framework for cross-border cooperation:*** Resolution authorities should be empowered and encouraged to achieve cooperative solutions with foreign resolution authorities.
- ***Crisis Management Groups:*** Home and key host authorities should maintain crisis management groups that actively review and report on resolvability and on the recovery and resolution planning process for G-SIFIs.
- ***Institution-specific cross-border cooperation agreements:*** Should be in place among relevant authorities to manage the sharing of information and specify responsibilities in respect of all G-SIFIs.
- ***Resolvability assessments:*** Resolution authorities should regularly undertake resolvability assessments for all G-SIFIs, and should be able to require changes to business practices, structure or organization.
- ***Recovery and resolution planning:*** Jurisdictions must require planning for the recovery and resolution of firms that could be systemically significant.
- ***Information sharing:*** Jurisdictions should eliminate impediments to the domestic and cross-border exchange of information among authorities, both in normal times and during a crisis.

Figure 7. *Overview of the FSB Key Attributes.*
Source: Author's illustration, based on IMF (Aug 2012).

[227] Although not explicitly called for by the standard, many of the Key Attributes' provisions (e.g. resolution powers) could usefully be applied to any financial institution regardless of its systemic importance, albeit in a proportional manner. See IMF (Aug 2012), p. 7.

[228] Recovery plans, prepared by each financial institution, should set out credible options for restoring financial or operational soundness in a range of idiosyncratic and market-wide stress scenarios. Resolution plans, developed by resolution authorities using information provided by financial institutions, set out the resolution strategy, the applicable resolution tools and a detailed operational plan for implementing that strategy. In this context, resolvability assessments to evaluate the feasibility of the resolution strategy are an intrinsic part of the resolution planning process, and national authorities should have powers to require financial institutions to adopt measures to address impediments to their resolvability. See FSB (Oct 2014).

With regard to the resolution toolkit, the Key Attributes call for the resolution authorities to have a broad range of powers to deal with a failing bank without exposing public funds to loss. In most countries, such powers are exercised in the context of resolution proceedings, which may be administrative or judicial in nature and generally take the form of official administration or liquidation[229]. The resolution powers envisaged under the Key Attributes can be broadly grouped into three categories: i) powers to intervene quickly (prior to insolvency) and assume control from existing owners and managers, such as the power to replace the bank's board management or to appoint an administrator to temporarily manage the bank, ii) powers to implement the resolution strategy, such the transfer of assets to an existing entity, a bridge bank or an asset management company, or the power to bail-in[230] creditors to recapitalize the failed bank, and iii) powers to support the resolution, for example, by suspending third party actions or rights that could otherwise undermine it, such as payments to unsecured creditors, or the imposition of the obligation on related group entities to continue to provide essential services and functions.

To ensure effective protection of property rights, the Key Attributes set out the 'no creditor worse off than in liquidation' principle (**NCWL**), that is a mechanism to compensate creditors of the non-viable bank for any losses that they could suffer over and above those they would have incurred in liquidation. In this sense, resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general principle of equal treatment of creditors of the same class (*pari passu*), with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm's failure or to maximise the value for the benefit of all creditors as a whole. In particular, CET1 and AT1 instruments should absorb losses first, then subordinated debt (including all Tier 2 regulatory capital instruments), and, finally, senior unsecured debt. Once equity and other relevant capital instruments have been wholly or partially written down, liabilities non-excluded by law from resolution are written-down partially and what remains is converted to newly issues shares to the extent necessary to enable the resolved bank to comply with binding capital ratios again. In this respect, importantly, the Key Attributes exclude certain types of liabilities from the application of capital restoration mechanisms, such as secured creditor claims (up to the value of the security) and insured deposits, and leave open the possibility for resolution authorities to exclude other liabilities that are of systemic or strategic economic importance (e.g., inter-bank and retail deposits, payment and settlement obligations, or trade-finance obligations).

[229] The Key Attributes recognize that there is no 'one-size-fits-all' approach to resolution and that different approaches need to be taken, depending on the institution and its circumstances. Liquidation, when combined with a quick deposit insurance payout, may efficiently resolve a small bank. But when a failing bank is systemic, the authorities may seek to resolve the institution in a manner that preserves its systemic activities as a going concern. The resolution toolkit therefore needs to be comprehensive, and the authorities need to be able to act with the necessary speed and flexibility, subject to appropriate legal safeguards and due process. See IMF (Aug 2012), p. 8.

[230] Under this technique, the authorities unilaterally restructure the liabilities of the bank by writing them down and, in some cases, converting them into equity. The objective of this exercise is to return the bank to compliance with Basel prudential requirements and restore its viability. Such a unilateral debt restructuring directly imposes losses on the private stakeholders of the ailing firm. In contrast to a purchase and assumption transaction (which, by definition, involves the transfer of assets and liabilities to another institution), a 'bail-in' may be executed without making any transfers to other financial institutions. For an in-depth discussion of the Key Attributes and the resolution toolkit (including bail-in), see IMF (Aug 2012).

As mentioned, the ultimate objective of a resolution publicly-administrated procedure is to return the bank to compliance with Basel prudential requirements and restore its viability. To ensure that this goal is achieved, in November 2015 the FSB introduced in the international prudential framework an additional loss-absorbing buffer of eligible liabilities that falls under the name of Minimum Total Loss-absorbing Capacity (**TLAC**). In the intention of the FSB, the TLAC standard shall further strengthen the capital base of systemically important institutions beyond Basel capital requirements should they need to restore their capital position due to financial stress and losses in portfolio values. The main features and the phasing-in period of the TLAC standard, as well as the eligibility criteria of TLAC-eligible subordinated bonds, are discussed in more detail in the next Paragraph.

3.3. Main features and application of the TLAC standard

As part of the international community's regulatory efforts to strengthen the G-SIB framework and make credit institutions with systemic relevance promptly resolvable in case of bankruptcy[231], in November 2015 the FSB published the term sheet of a new global loss-absorbing standard that, in connection with Basel minimum capital requirements, aims at ensuring that financial institutions have adequate loss-absorbing capacity to restore their viability in the event of a crisis. This new prudential requirement falls under the name of TLAC[232]. Being designed by international standard-setters, the TLAC requirement applies only to the 30 largest global banks as identified by the FSB[233], since they are deemed to be systemically important and their failure can have an adverse impact on financial stability. The key objective of this standard is to ensure that G-SIBs have the internal loss-absorbing and recapitalisation capacity necessary to ensure that, in and immediately following a resolution, critical functions can be continued without taxpayers' funds (i.e. public funds) or financial stability being put at risk. In particular, the TLAC requires that G-SIBs shall have sufficient debt TLAC-eligible instruments available to make their holders absorb losses (enabling a 'bail in'), instead of using public funds (conducting a 'bailout'), while the resolution process is underway. To this end, and to prevent risk of contagion, the FSB term sheet requires G-SIBs to deduct any holdings of TLAC-eligible securities issued by other G-SIBs from their own TLAC requirement[234].

In the FSB framework, the TLAC requirement is designed as a Pillar 2 requirement to be set by national authorities for each G-SIB, in order to account for different recovery and resolution plans, systemic footprints, business models, risk profiles and corporate structures. Accordingly, such firm-specific capital buffer is determined by resolution authorities taking into account the Key Attributes and the FSB's TLAC principles. Nevertheless, the TLAC standard also incorporates a Pillar 1 common minimum requirement to help achieve a level playing field internationally, which will be phased-in under two different time periods as of 2019 and 2022, respectively[235]. In particular, to provide home and host authorities with confidence that G-SIBs can be resolved in an orderly manner

[231] At the St. Petersburg Summit in 2013, G-20 Leaders called on the FSB, '*in consultation with standard setting bodies, to assess and develop proposals by end-2014 on the adequacy of global systemically important financial institutions' loss-absorbing capacity when they fail*'. See G-20 Leaders' Declaration, St. Petersburg Summit, 6 September 2013, Section 68.

[232] See FSB (Nov 2015).

[233] Currently, 8 of these banks are domiciled in the EU.

[234] See FSB (Nov 2015), Section No 15.

[235] See Figure 8. in this Paragraph for a graphic visualisation of the phasing-in of the TLAC standard under the two different temporal segments.

and to foster mutual trust between home and host authorities in a group resolution strategy, the TLAC standard is structured upon two different components: external and internal TLAC[236].

On the one hand, external TLAC applies on an individual basis to certain financial entities composing the G-SIB group. In particular, external TLAC is issued to third parties by the entities to which resolution tools will be applied under the group resolution strategy. These entities are known as 'resolution entities', and a resolution entity and its subsidiaries constitute a 'resolution group'. In substance, resolution entities are those financial institutions to which resolution measures are applied based on the G-SIB's resolution plan agreed by its home and key host authorities[237]. The amount of external TLAC issued must be sufficient to provide loss-absorbing resources to the resolution group as a whole. Therefore, a resolution entity's minimum TLAC requirement will be set in relation to the consolidated balance sheet of the resolution group (that is, the consolidated balance sheet of the resolution entity and its subsidiaries).

On the other hand, internal TLAC comprises capital instruments or other liabilities issued, directly or indirectly, to a resolution entity by subsidiaries operating outside the resolution entity's home jurisdiction that are deemed material within the resolution group[238]. According to the FSB terminology, these are called 'material sub-groups'[239]. In this sense, internal TLAC is designed as a mechanism whereby losses and the recapitalisation needs of a G-SIB's material subsidiaries may be passed to the resolution entity of the resolution group. This is achieved by writing down the internal TLAC or converting it to equity without the subsidiaries entering into resolution. Internal TLAC must amount to at least 75-90% of what that sub-group would have to provide if it were itself a resolution entity[240], and it must be 'pre-positioned' on the balance sheet, i.e. rank above other creditors of that sub-group, so that it is available to absorb losses when resolution measures (such as a bail-in), are taken at the parent company level. The calibration of internal TLAC within the range of 75-90% is determined by the host authority of the material sub-group in consultation with the home authority of the G-SIB resolution group, and the calculation is based on the sub-consolidated balance sheet of the material sub-group. Ultimately, the amount of pre-positioned internal TLAC should provide comfort

[236] For a description of external and internal TLAC requirements, see also BCBS (Aug 2020).

[237] A G-SIB may have one or more resolution entities. G-SIBs that follow a single point of entry (**SPE**) resolution strategy (all resolution action applies at the top of the banking group) will have only one resolution entity. G-SIBs that follow a multiple point of entry (**MPE**) resolution strategy (resolution measures are implemented at various operating companies or subsidiaries) will have multiple resolution entities and, therefore, multiple resolution groups.

[238] The requirements for internal TLAC are elaborated in Sections 16 to 19 of the FSB's term sheet. These are supplemented by the 2017 FSB's Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs ('Internal TLAC'). See FSB (Jul 2017).

[239] See FSB (Nov 2015), Section No 16. Specifically, a 'material sub-group' consists of one or more direct or indirect subsidiaries of a resolution entity that meet at least one of the following criteria on a solo or sub-consolidated basis: i) have more than 5% of the consolidated RWAs of the G-SIB group, ii) generate more than 5% of the total operating income of the G-SIB group, iii) have a total leverage exposure measure larger than 5% of the G-SIB group's consolidated leverage exposure measure, or iv) have been identified by the G-SIB's competent resolution authorities as material to the exercise of the G-SIB's critical functions. A material sub-group might be, for example, an intermediate holding company that consolidates operating subsidiaries in a host jurisdiction under a single holding, or a subgroup composed of an operating subsidiary and one or more subsidiaries under its control. Finally, it is worth mentioning that, as a general rule, foreign subsidiaries composing a material sub-group should be established in the same jurisdiction. Exceptionally, a material sub-group may include subsidiaries incorporated in more than one jurisdiction where the competent resolution authorities agree that this is necessary to support the G-SIB's resolution strategy and ensure that internal TLAC is distributed appropriately within the material sub-group.

[240] As it will be discussed under Chapter 3, Paragraph V., the 2019 EU implementation of the TLAC standard requires foreign subsidiaries of non-EU banking groups to hold 90% of TLAC-eligible liabilities.

to host authorities that adequate resources are available to absorb losses and meet recapitalisation needs in the local material sub-group in case resolution is triggered (or, also, in order to avoid resolution). Accordingly, the use of internal TLAC is intended to be a last resort, where the parent is unable to recapitalise a distressed subsidiary or sub-group, as it results in the write-down and conversion of the parent's claims on the subsidiary into new equity[241].

The G-SIB's TLAC buffer can be met by instruments that are eligible for the minimum regulatory capital requirement, together with senior unsecured debt instruments that satisfy the FSB TLAC eligibility criteria. The FSB eligibility criteria for TLAC instruments resemble to a large extent the ones set out by the BCBS with regard to AT1 and Tier 2 debt instruments[242]. As such, the main eligibility criteria for TLAC debt instruments are the following[243]:

i. a minimum remaining contractual maturity of at least one year;
ii. not redeemable by the holder prior to maturity, unless the earliest redemption date would result in a remaining maturity of at least one year;
iii. not redeemable by the issuer prior to maturity without supervisory approval;
iv. not funded directly or indirectly by the resolution authority;
v. should contain a contractual trigger or be subject to a statutory mechanism that permits the relevant resolution authority to effectively write it down or convert it to equity in resolution; and,
vi. must be subordinated to liabilities that are not TLAC eligible (such as deposits and structured products).

The same liabilities are excluded from both external and internal TLAC. These include insured, short-term and sight deposits, liabilities arising from derivatives or, more generally, any liabilities that, under the laws governing the issuing entity, are excluded from bail-in or cannot be written down or converted into equity by the relevant resolution authority[244].

According to the FSB term sheet, the TLAC requirement will be phased-in as follows[245]:

- Phase 1 (as of January 2019) – 16% of RWAs and 6% of leverage exposure measure; and
- Phase 2 (as of January 2022) – 18% of RWAs and 6.75% of leverage exposure measure.

While the introduction of a 'double-ratio' requirement should ensure that the TLAC buffer is successfully built by banks, it has been argued that this method of calculating the TLAC using both RWA- and leverage-based methods could create incentives for banks to 'game' the reference metrics. Indeed, while the leverage ratio is based primarily on reported numbers and is therefore less flexible, the RWAs ratio, in particular when calculated under the advanced IRB approaches, is more susceptible to subjectivity[246]. In order to reduce their TLAC, banks that have a lower risk profile (i.e.

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[241] See BCBS (Aug 2020).
[242] See Chapter 1, Paragraph II.
[243] See FSB (Nov 2015), Section No 9.
[244] See FSB (Nov 2015), Section No 10.
[245] See FSB (Nov 2015), Section No 4.
[246] To address concerns raised since the outbreak of the GFC, the 2017 Basel IV reform will aim at reducing RWAs volatility by, *inter alia*, constraining the application of IRB approaches by banks to certain asset classes and by introducing binding output floors in the calculation of RWAs. See Chapter 1, Paragraph IV.

RWAs' density below 37.5%) may be encouraged to 'optimise' their RWA profile and/or make adjustments to their business model in a way that, ultimately, expose them more to higher risks[247].

As mentioned, regulatory capital used to cover minimum requirements under Basel III, i.e. CET1, AT1 and Tier 2 capital, can also be used to satisfy the TLAC requirement. At the same time, only CET1 capital that is in excess of meeting the minimum regulatory capital and TLAC requirements can be used to cover the buffers and G-SIB capital surcharge. Figure 8. below illustrates the composition and phasing-in of the TLAC standard and Basel capital requirements.

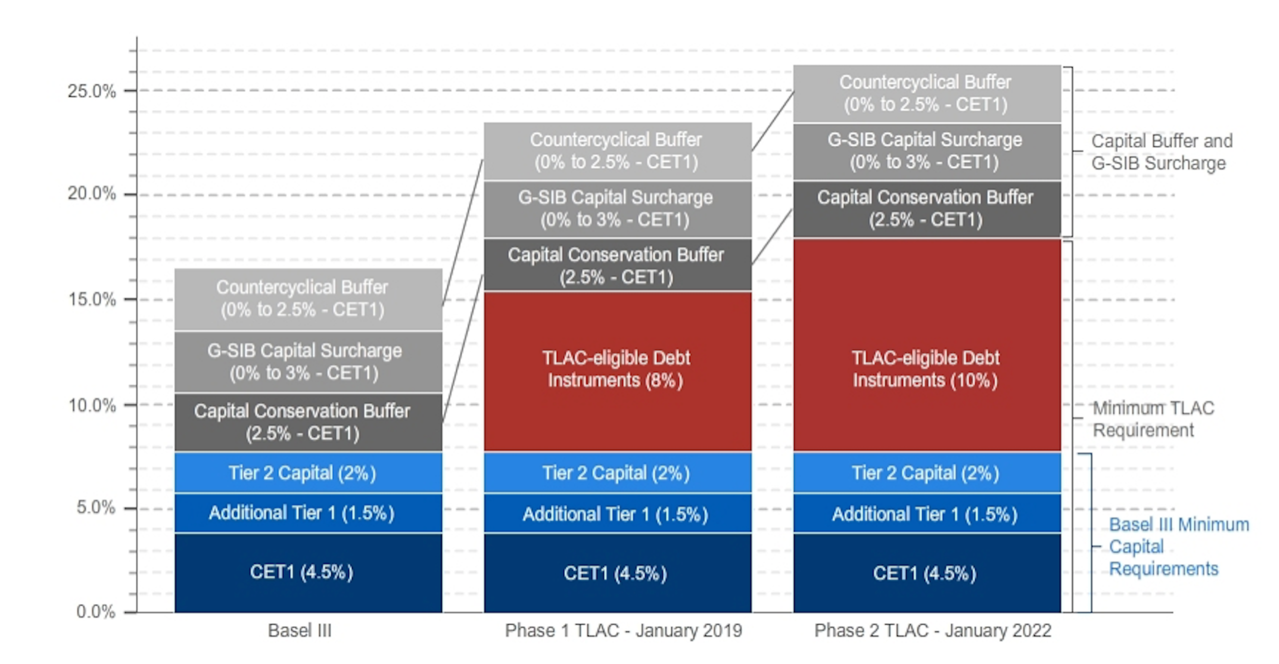

Figure 8. *Composition and phasing-in of TLAC and Basel capital requirements.*
Source: Author's illustration.

[247] In a nutshell, RWA density is defined as the average risk of the credit exposure of a bank. It is calculated by dividing RWA by total exposure. If TLAC is defined as the sum of 18% of RWA and 6.75% of total exposure, TLAC for banks with RWA density below 37.5% is determined by the leverage ratio criterion, whereas the RWA criterion becomes the main determinant when RWA density exceeds that level. For an overview of the TLAC standard and a discussion of the possible policy issues in connection with the 'double-ratio' requirement, see Stiefmüller (2016).

IV. The Finalization of Basel III (or 'Basel IV'): Key Features

As discussed, the adoption of the Basel Accords played a crucial role in shaping international financial regulation and strengthening banking systems worldwide over the last thirty years[248]. As a response to the disastrous economic effects of the 2007-08 global financial crisis, Basel III provided regulatory guidance to policy-makers and market participants alike by laying down a significantly complex prudential framework targeting most of the deficiencies characterising the pre-crisis regulatory environment: insufficient capital reserves of banking intermediaries; excessive leverage; procyclicality and systemic risk concentration; liquidity shortage and maturity mismatches; lack of disclosure; inappropriate incentive structures. These reforms have demonstrably helped to strengthen the global banking system. In the reference period 2011-2018, the Tier 1 leverage ratio of major internationally active banks has increased by over 65% (from 3.5% to 5.8%), while their CET1 risk-weighted ratio has increased by over 70% (from 7.2% to 12.3%). The bulk of this change was achieved by an increase in banks' CET1 capital resources (from EUR 2.1 trillion to EUR 3.7 trillion). There has also been a corresponding reinforcement of banks' liquidity: holdings of liquid assets have increased by 30% (from EUR 9.2 trillion to EUR 11.6 trillion)[249].

However, only a few years after the enactment of Basel III, policy commentators commenced to highlight concerns about some fundamental underpinnings of its prudential rules. While the positive financial stability effects produced by the post-GFC framework were acknowledged worldwide, one of the main criticisms to Basel III concerned the continuing over-reliance by supervisors, for the determination of capital requirements, on RWAs calculated by credit institutions with unwieldy probabilistic econometric IRB models, which demonstrated to be by construction unable to deal with idiosyncratic or systemic shocks hitting the financial system. Indeed, even though concerns on the ability of banks to 'game the system' by keeping RWAs artificially low through non-transparent data inputs were raised by multiple studies since the adoption of Basel II[250], the BCBS, through the Basel III Accord, while enhancing the numerator of the capital adequacy ratio, focused little on restoring the credibility of RWAs calculations and improving the comparability of banks' capital ratios[251]. As a consequence, even following the GFC and the wide-ranging regulatory response enacted by the Basel Committee, risk-based capital ratios continued to be an unreliable parameter to discern between a sound bank and a bank that would eventually require public intervention due to supervening unviability[252]. Still in 2013, ratios of capital to RWAs across the largest European banking groups

[248] See Chapter 1, Paragraphs I., II. and III.
[249] Data are drawn from Ingves (2018).
[250] See Chapter 1, Paragraph 1.4.
[251] As acknowledged by the Chairman of the Committee himself, at the peak of the GFC, a wide range of stakeholders lost faith in banks' internally modelled risk-weighted capital ratios. The complexity and opacity of internal models, the degree of discretion provided to banks in modelling risk parameters, and the use of national discretions all contributed to an excessive degree of RWAs variation. See Ingves (2018).
[252] See Micossi (2013); IMF (Apr 2009). As a seemingly evidence of these findings, in 2011 the cross-border operating Dutch bank *SNS REAAL* and the Franco-Belgian bank *Dexia* entered bankruptcy and required governmental bail-out even if they both displayed adequate capital ratios above Basel minimum thresholds. Indeed, with regard to the *Dexia* case specifically, the institution ranked 12th of the 90 tested banks under the 2011 EBA EU-wide stress test, with a stressed core Tier-1 ratio of more than twice the minimum threshold of 4% (as discussed above, in 2011 Basel III was not in force yet). However, the equity ratio amounted only to about 1.9%, representing one-sixth of the core Tier-1 ratio of the bank at year-end 2010. In addition to this, *Dexia* was significantly exposed to riskier assets, namely i) off-balance sheet assets that prompted losses in downturns as they were not valued according to their fair value under IASB accounting principles, and ii) large holdings of Greece, Ireland, Italy, Portugal and Spain's sovereign bonds, which overall amounted to around

exhibited large variations – ranging between below 20% and above 60% of total assets – implying that similar Basel capital ratios may provide inconsistent estimations of risk and correspond to widely different leverage ratios[253]. This worryingly large variation in banks' estimated RWAs was confirmed by a BCBS study on risk weights for credit risk in the banking book, which found that banks' reported capital ratios could vary by 50% for the same hypothetical portfolio[254].

The loss of confidence by markets and investors in banks' reported capital ratios clearly highlighted the need for tighter limits to the way in which RWAs were calculated and greater transparency. As a response, in December 2017, the BCBS published a set of reforms seeking to restore the credibility of RWA calculations, and as a result the public's confidence in the banking system. While the BCBS deemed these standards necessary for the completion of the post-GFC regulatory reform agenda, and, hence, defined its reform as 'finalisation of Basel III', the banking community and policy commentators considered the changes as significant and distinctive, so that they labelled them as 'Basel IV'[255]. In substance, while Basel I and Basel III focused primarily on strengthening the numerator of the capital adequacy ratio (i.e. the quality, loss-absorbing capacity and transparency of minimum capital requirements), Basel IV revises and updates the supervisory measurement standards introduced by Basel II with regard the denominator of the ratio (i.e. the transparency and consistency of RWAs' methods of calculations to determine capital levels)[256].

Under this perspective, the key objectives of Basel IV are:

EUR 22 billion (the total assets of the bank amounted to EUR 53 billion). *Dexia*'s credit risk exposure to public authorities made the bank very vulnerable to the Eurozone sovereign debt crisis triggered in the aftermath of the GFC. In October 2011, authorities from Belgium, France and Luxembourg authorised the implementation of a EUR 94 billion public-funded rescue package to avoid regional financial disruption. As such, the case of *Dexia* clearly showed that a core Tier-1 ratio above Basel minimum standards did not automatically imply that a bank was safer, as well as that RWAs calculations needed profound adjustments to better calibrate exposures to real risk. On a separate note, the failure of *Dexia* also fuelled discussions on the introduction of a large exposures requirement to sovereigns (currently, still not incorporated into the Basel prudential framework) and the need for regulatory recalibration with regard to low risk weights for exposures to governments and other public authorities. For an in-depth analysis of the *Dexia* case, see de Groen (2011).

253 See Micossi (2013).

254 Under a risk management perspective, generally credit risk constitutes the largest component of banks' RWAs and a dominant source of overall variations in RWAs at the bank level. In its study, the Committee found considerable variation across banks in average RWAs for credit risk and noted that credit risk accounted for 77% of the observed dispersion. In contrast, market risk and operational risk revealed to be less important sources of RWAs variability, as they stood at 11% and 9%, respectively. In particular, much of the variation (up to three quarters) under credit risk was explained by the underlying differences in the risk composition of banks' assets, reflecting differences in risk preferences as intended under the risk-based capital framework. The remaining variation was driven by diversity in both bank and supervisory risk management practices. See BCBS (Jul 2013).

255 The BCBS most recent comprehensive package reform was published under the single document '*Basel III: Finalising post-crisis reforms*'. See BCBS (Dec 2017). In the literature, see, among others, Dias et al. (2021); Yeoh (2018); Amorello (2016).

256 In parallel to the adoption of Basel IV, in 2017 the BCBS commenced work to review the prudential framework for market risk via the 'fundamental review of the trading book' (**FRTB**), aimed at reducing the variability of market risk-weighted assets across global markets. Following the publication of a consultation paper in June 2017, in January 2019 the BCBS published the revised supervisory framework on the calculation of minimum capital requirements for market risk. The key improvements against the Basel II framework include: i) a clearly defined boundary between the trading book and the banking book, ii) an IRB approach that relies upon the use of expected shortfall models and sets out *ad hoc* capital requirements for specific risk factors that are deemed non-modellable, iii) a SA that is risk-sensitive and is calibrated to serve as a credible fallback to the IRB approach, intended to be used by banks that have small or non-complex trading portfolios. Due to the outbreak of the coronavirus pandemic, the entry into force of the FRTB reform, originally foreseen at January 2022, has been postponed to 1 January 2023. On the FRTB reform, see BCBS (Jan 2019).

- enhancing the robustness and risk sensitivity of the SAs for credit risk and operational risk, which will make banks' capital ratios more comparable;
- constraining the use of IRB approaches, including by removing the use of the most advanced modelled approaches for certain credit risk asset classes and for calculating operational risk; and
- complementing the risk-weighted capital ratio with a finalised leverage ratio and a revised and robust output floor.

Accordingly, Basel IV has a twofold nature. On the one hand, supervisors aim at making the simpler SA for credit risk, market risk, credit valuation adjustment (**CVA**) risk[257] and operational risk a more credible alternative to the IRB risk measurement approaches. On the other, the BCBS aims at reducing differences and regulatory arbitrage opportunities between IRB models by introducing a more restrictive aggregate output capital floor, which means that banks using internal models to determine the amount of RWAs may only deviate to a certain extent from the amount calculated by the SA. Arguably, this will limit the benefits banks can derive from using IRB models to calculate minimum capital requirements and model low-default portfolios.

More into details, the key regulatory aspects underpinning the Basel IV reform aims at addressing the shortcomings highlighted by the GFC relating to the excessive complexity of the IRB approaches, the lack of comparability in banks' IRB modelled capital requirements and the lack of robustness in modelling certain asset classes. To achieve this, Basel IV resolves to, first, remove the option to use the advanced IRB approaches for certain asset classes that cannot be modelled in a robust and prudent manner, namely large and mid-sized corporates and exposures to banks and other financial institutions[258]. As a result of these changes, banks with supervisory approval can use the Foundation IRB approach only to model exposures towards such corporates and financial entities. Importantly, the Foundation IRB approach removes two significant sources of RWAs variability as it applies fixed values to the LGD and EAD parameters. Second, Basel IV introduces aggregate output floors (for metrics such as PD and LGD) to ensure a minimum level of conservativism in model parameters for asset classes where the IRB approach remain available. In particular, Basel IV introduces an aggregate output floor, which will ensure that banks' RWAs generated by IRB models are no lower than 72.5% of RWAs as calculated by the Basel IV framework for SAs[259]. Third, Basel IV provides greater specification of assets' estimation practices to reduce RWAs variability, particularly in relation to corporate exposures, retail exposures and high-volatility commercial real estate[260].

On the one hand, the granularity and the risk sensitivity of the standardised measurement approach is improved, *inter alia*, through the amendments to the Basel II single flat risk weight applying to all

[257] Banks that undertake derivative or securities financing transactions are subject to the risk of incurring mark-to-market losses because of the deterioration in the creditworthiness of their counterparties (which can include sovereigns, banks, other financial institutions and non-financial corporations). This potential source of loss due to changes in counterparty credit spreads and other market risk factors is known as CVA risk. CVA risk is complementary to the risk of a counterparty defaulting, or counterparty credit risk.
[258] See BCBS (Dec 2017), p. 7 ff.
[259] See BCBS (Dec 2017), p. 137 ff. This safeguard is gradually phased in over a six-year transition period. At the start, the output floor limits the deviation to not go below 50% of the standardised calculation, the binding lower threshold then gradually increases over time and finally reaches 72.5% when fully phased-in (during the phase-in period supervisors can, at national discretion, cap an output floor-induced increase of a bank's RWAs).
[260] See BCBS (Dec 2017), p. 53 ff.

residential mortgages by requiring banks to weight the mortgage risk depending on the loan-to-value ratio of the mortgage itself. In addition, Basel IV develops a more granular look-up table for exposures to corporates by introducing a specific weight that applies to exposures to small and medium-sized enterprises, and for retail exposures, by introducing a more granular treatment distinguishing between different retail exposures such as revolving facilities (where credit is typically drawn upon) and transactors (where the facility is used to facilitate transactions rather than a source of credit).

Finally, Basel IV introduces a leverage ratio buffer for G-SIBs, which will take the form of a Tier 1 capital buffer set at 50% of a G-SIB's risk-weighted capital buffer. For example, a G-SIB subject to a 2% risk-weighted G-SIB capital surcharge would be subject to a 1% leverage ratio buffer requirement. The leverage ratio buffer takes the form of a capital buffer akin to the capital buffers in the risk-weighted framework as described thus far. As such, the leverage ratio buffer will be divided into five ranges. As is the case with the capital framework, capital distribution constraints will be imposed on a G-SIB that does not meet its leverage ratio buffer requirement. The distribution constraints imposed on a G-SIB will depend on its CET1 risk-weighted ratio and Tier 1 leverage ratio. A G-SIB that meets: i) its CET1 risk-weighted requirements (defined as a 4.5% minimum requirement, a 2.5% capital conservation buffer and the G-SIB higher capital buffer) and; ii) its Tier 1 leverage ratio requirement (defined as a 3% leverage ratio minimum requirement and the G-SIB leverage ratio buffer) will not be subject to distribution constraints. A G-SIB that does not meet one of these requirements will be subject to the associated minimum capital conservation requirement (expressed as a percentage of earnings). A G-SIB that does not meet both requirements will be subject to the higher of the two associated conservation requirements[261].

The revised Basel IV standards would take effect from 1 January 2022 and be phased in over five years. However, due to the outbreak of the Covid-19 pandemic, the BCBS postponed the starting implementation date of Basel IV of one year to no later than 1 January 2023. This also affects the transitional arrangements for the output floor, deferred to 1 January 2028[262].

[261] See BCBS (Dec 2017), pp. 140-141.
[262] See BCBS press release dated 27 March 2020 '*Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to Covid-19*'.

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List of Abbreviations – Chapter Two

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BCBS	Banking Committee on Banking Supervision
BIS	Bank for International Settlements
BRRD I	Banking Recovery and Resolution Directive No I (*2014/59/EU*)
BRRD II	Banking Recovery and Resolution Directive No II (*2019/879/EU*)
BSC	Banking Supervision Committee
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CJEU	Court of Justice of the European Union
CMU	Capital Markets Union
COREP	Common Reporting Framework for Solvency Ratios
CRD IV	Capital Requirements Directive No IV (*2013/36/EU*)
CRD V	Capital Requirements Directive No V (*2019/878/EU*)
CRR I	Capital Requirements Regulation No I (*2013/575/EU*)
CRR II	Capital Requirements Regulation No II (*2019/876/EU*)
DG(s)	Directorate(s) General (of the ECB)
DG/HOL	DG Horizontal Line Supervision
DG-MS I	DG Micro-Prudential Supervision I
DG-MS II	DG Micro-Prudential Supervision II
DG-MS III	DG Micro-Prudential Supervision III
DG-MS IV	DG Micro-Prudential Supervision IV
DG/OMI	DG On-site and Internal Model Inspections
DG/SGO	DG SSM Governance and Operations
DG/SIB	DG Systemic and International Banks
DG/SPL	DG Specialised Institutions and Less Significant Institutions
DG-SSB	Directorate General Secretariat to the Supervisory Board
DG/SSR	DG Strategy and Risk
DG/UDI	DG Universal and Diversified Institutions
D-SIBs	Domestic Systemically Important Bank(s)
DTI	Debt(service)-to-income
EB	Executive Board (of the ECB)
EBA	European Banking Authority
EBU	European Banking Union

EC	European Commission
ECB	European Central Bank
ECHR	European Convention on Human Rights
ECSC	European Coal and Steel Community
EFSM	European Financial Stabilisation Mechanism
EIOPA	European Insurance and Occupational Pension Authority
EMU	European Monetary Union
EP	European Parliament
ERM II	Exchange Rate Mechanism II
ESAs	European Supervisory Authorities
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FICOD	Financial Conglomerates Directive (*2002/87/EC*)
FR	Framework Regulation (*2014/468/EU*)
FSB	Financial Stability Board
FSC	Financial Stability Committee
GDP	Gross Domestic Product
GFC	(2007-08) Global Financial Crisis
GovC	Governing Council (of the ECB)
JST(s)	Joint Supervisory Team(s)
IFD	Investment Firms Directive (*2019/2034/EU*)
IFR	Investment Firms Regulation (*2019/2033/EU*)
IMF	International Monetary Fund
IRB	Internal-Ratings Based
ITS(s)	Implementing Technical Standard(s)
LCR	Liquidity Coverage Ratio
LOLR	Lender of Last Resort
LSI(s)	Less Significant Institution(s)
LTD	Loan-to-deposit
LTI	Loan-to-income
LTV	Loan-to-value
MDA	Maximum Distributable Amount

MF	Macroprudential Forum
MoU	Memorandum of Understanding
MP	Mediation Panel
NCA(s)	National Competent Authority - ies
NCB(s)	National Central Bank(s)
NDA(s)	National Designated Authority - ies
NMA(s)	National Macroprudential Authority - ies
NSFR	Net Stable Funding Ratio
OJ	Official Journal (of the European Union)
OND(s)	Options and Discretion(s)
O-SIB(s)	Other Systemically Important Bank(s)
O-SII(s)	Other Systemically Important Institution(s)
pMS(s)	participating Member State(s)
RTS(s)	Regulatory Technical Standard(s)
SA	Standardised Approach
SB	Supervisory Board (of the ECB)
SEP	Supervisory Examination Programme
SI(s)	Significant Institution(s)
SME(s)	Small and Medium Enterprise(s)
SRB	Single Resolution Board
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
SRMR	Single Resolution Mechanism Regulation (*2014/806/EU*)
SSMR	Single Supervisory Mechanism Regulation (*2013/1024/EU*)
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union

CHAPTER TWO

THE ENFORCEMENT OF THE BASEL STANDARDS WITHIN THE EU: THE SINGLE SUPERVISORY MECHANISM

I. The Europeanisation of Banking Prudential Supervision

The 2007-08 global financial crisis (**GFC**) crystallised awareness of the importance of reforming the institutional framework and the financial safety net of most advanced countries worldwide. According to the international benchmark, the revised financial regulatory regime to be incorporated globally in each advanced economy had to comprise, at a minimum, four pillars: i) ongoing prudential supervision and supervisory early intervention, ii) resolution of financial institutions, iii) deposit insurance, and iv) central bank liquidity assistance[263]. Under this perspective, the establishment of the Single Supervisory Mechanism (**SSM**) represents the policy response, at the Eurozone level, to the first one of these key regulatory measures identified by the International Monetary Fund (**IMF**). At the same time, the SSM is also one of the three pillars composing the European Banking Union (**EBU**) project[264]. The SSM centralises the supervision of significant Eurozone-based banks at the European Central Bank (**ECB**), with the aim to address key deficiencies exposed at European level by the global financial crisis and the subsequent sovereign debt crisis[265] in relation to the prudential

[263] See IMF (Feb 2020), p. 9.

[264] To increase the resilience of the Economic and Monetary Union (**EMU**) and restore public confidence in the single currency following the outbreak of the GFC, and the subsequent sovereign debt crisis, at the Euro Area Summit of 29 June 2012 the Heads of State of the Euro area decided upon policy measures to establish an ambitious political project, which fell under the name of 'European Banking Union', with the aim at ultimately breaking the 'vicious circle between banks and sovereigns'. The European Commission (**EC**) endorsed the Euro Area Summit decision and, in September 2012, published a roadmap towards the establishment of the Banking Union. The EBU can be understood as a regulatory framework, or European financial safety net, built upon three pillars, which centralises to the European level administrative functions carried out, until its establishment, by Eurozone national authorities. In particular, the first pillar establishes a single mechanism for the supervision of banks, the second pillar lays down a Eurozone-wide integrated crisis management regime, and a third pillar (in contrast to the other two pillars, at present not operational yet) would provide for a common system for deposit guarantees. On the rationale and structure of the EBU, see EC (2012). In the academic literature, see, among others, Chiti and Santoro, eds., (2019); Beck, ed., (2012). With a particular focus on the problem of judicial protection within the EBU, see Banca d'Italia (2018). On the SSM specifically, see Bassani (2019); Lackhoff (2017); Gortsos (2015); D'Ambrosio (2013). For a comprehensive overview of the changes to the EMU regulatory framework in response to the GFC, particularly with regard to legislation on Member States' budgetary soundness and the EC's oversight role of national economic policies, see Smits (2015).

[265] Although for different reasons, following the outset of the GFC, several EU countries experienced a steep increase in their sovereign bond yields as well as in their banks' cost of funding. This became known as the 'vicious circle' between sovereigns and banks, due to which banks' weak solvency ratios put pressure on their countries' fiscal position, and pressure on highly indebted sovereigns led to increasing cost of funding for banks headquartered in these countries. This vicious circle became evident in the movement of CDS spreads of banks and sovereigns, as such spreads became highly positively correlated with each other. This led to a dramatic fragmentation of the single market. The cost of funding for banks and sovereigns in the Eurozone became again something confined to national borders, as funding costs diverged across countries in the same way as before the establishment of the single market in the past decades. This trend toward renationalisation could be seen clearly by analysing intra-Eurozone cross-border banking claims. Until about 2008, cross-border claims of banks based in the Eurozone core (essentially Germany and its smaller neighbours) toward the Eurozone periphery grew quickly, multiplying several times. But since the end of the credit boom in 2008, they plummeted from about EUR 1.6 trillion to less than half that amount. Similarly, home-host cooperation between national authorities collapsed and massive ring-fencing measures were put in place. Between 2007 and the end-2008, the degree of financial openness dropped by 16% in Germany, 18% in Italy and 21% in France. As a consequence, banks started re-organizing their activities and business plans to take account of financial fragmentations, so that soon the impairment of the single market spilled over into the real sector. Small and medium-sized enterprises (**SMEs**) started to pay increasingly divergent

supervision of banks. In particular, the two crises ruthlessly underscored the complacency in supervisory action by national authorities and the lack of an integrated EU-wide regulatory approach to effectively managing the cross-border operations of EU banks. Indeed, the European Union's (**EU**) pre-crisis banking regulatory regime was characterised by fragmentation of supervision along national borders, with Member States' authorities operating on the basis of harmonised but far from identical regulations[266], and the 'light touch approach', or laxity in supervision, used by national supervisors towards 'national champions', that is banks that were considered key players in national economies and had to be supported through a partisan application of prudential rules and, if need be, also through the means of public finances – an attitude that has been labelled in the literature as '*banking nationalism*'[267]. The increasing competition brought about by the single market – and sustained by the introduction of the single currency in 1998 – put national regulators and supervisors under pressure to use national prudential regulation as a competitive lever to support national interests, creating an unlevel playing field and negative spill-over effects across Europe[268]. More broadly, the GFC clearly showed the limitations of the EU and, even more dramatically, of the Eurozone's institutional framework in terms of divergence between, on the one hand, EU banks' activities and geographical scope and, on the other, sovereigns' fiscal capacity. Indeed, one of the main goals of the creation of the EU single market and the EMU was to create a single market for goods and services across the Union, and in particular, an integrated banking market. Banks increasingly considered the EU as their domestic market, supported by regulators and policy makers. A first wave of mergers in the early 2000s led to the formation of several pan-European banks with an organizational structure and a geographical scope in line with the idea of a European Single Market[269]. The introduction of the single currency in the Euro area gave another boost in this direction by helping the integration of wholesale banking and bond markets[270]. However, the increasing integration of banking markets was not backed-up by broader EU-wide supervisory, crisis management and emergency fiscal support regimes, which largely limited cross-border consolidation and operations of European banking actors.

Against this backdrop, the establishment of the SSM as first pillar of the EBU is meant to foster the EU level playing field in banking services and ensure that Basel prudential, risk management and accounting rules are applied to European banks with an even hand, in a more distant and neutral way, and according to rigorous risk-based supervisory principles. This, in turn, would prevent national

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rates on bank loans depending on their geographical location. Following the aforementioned pattern of sovereigns and banks, SMEs located in EU countries characterised by high public debt and liquidity shortage (like Greece, Italy or Spain) started to pay increasingly greater loan rates compared to firms located in countries with stronger public finances (like Germany or The Netherlands). On the Eurozone sovereign debt crisis, see Allen et al. (2015); Enria (2015); Gros (2013).

[266] Basel II was implemented in the EU by way of two minimum harmonization Directives, i.e. Directive 2006/48/EC of 14 June 2006 and Directive 2006/49/EC of 14 June 2006. See Chapter 1, Paragraph 1.4.

[267] See Véron (2013).

[268] See Cappiello (2017), p. 424. A clear example of this 'race-to-the-bottom' in European pre-crisis banking regulation was the inconsistent definition of own funds across EU jurisdictions, heightened by the lack of appropriate and intrusive supervisory action and Pillar 3 disclosure arrangements that would have enabled investors and depositors to fully compare the quality of capital across banking systems. As discussed under Chapter 1, Paragraph II., Basel III substantially revised rules on minimum capital adequacy requirements to enhance the quality and transparency of the capital base of banks, and EU regulators rendered the international capital standards binding for all EU banks through the adoption of a directly applicable Regulation.

[269] Since then, the number of cross-border M&A transactions between European banks sharply decreased from around 100 in 2000 to less than 20 in 2018. See Enria (2019).

[270] See Allen et al. (2015), p. 36.

champions from being privileged and limit moral hazard[271], as well as opportunistic regulatory arbitrage by banks, with a view, ultimately, to enhancing financial stability and supporting economic growth at the regional level[272]. Under this perspective, the EBU, and the SSM as one of its three pillars, constitute a 'Copernican revolution' in banking law at European level. The SSM is established by EU Regulation 1024/2013 (**SSMR**)[273] and it has become operational on 4 November 2014. The establishment of the SSM changed fundamentally the European financial architecture, as it resulted in the denationalization of prudential supervision and, correspondingly, to the centralization to a European Institution[274] of the task to apply and enforce public banking requirements as derived from the soft law parameters of the Basel framework. Inevitably, a Europeanization of the decision-making process in banking supervision occurred[275]. In addition, the establishment of direct EU administration in the area of risk-based prudential supervision also influenced the development of common substantive and procedural laws, as the ECB, on the one hand, can adopt binding legal acts addressed to national competent authorities (**NCAs**)[276] in respect of less significant institutions (ECB as 'supervisor of supervisors', or supervisory oversight function), while, on the other, it provides, in its advisory function, opinions on proposed European prudential legislation. This fosters the creation of a 'single rulebook' for banking services at the EU level[277].

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[271] Recital 18 SSMR reads: '*[t]he exercise of the ECB's tasks should contribute in particular to ensure that credit institutions fully internalise all costs caused by their activities so as to avoid moral hazard and the excessive risk taking arising from it*'.

[272] In contrast to strengthening financial stability and the internal market for banking services, depositors' protection is not expressly mentioned by the SSMR as an outright objective of the SSM. However, it can be inferred from Recital 30 SSMR that safeguarding financial stability will also have a positive effect on depositors' protection.

[273] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. Article 1 of the SSMR reads: '*[t]his Regulation confers on the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions, with a view to contributing to the safety and soundness of credit institutions and* the stability of the financial system *within the Union and each Member State*'.

[274] Article 13.1 of the Treaty on European Union (**TEU**) lays down that the ECB, together with i) the European Parliament (**EP**), ii) the European Council, iii) the Council of the European Union (the '**Council**'), iv) the EC, v) the Court of Justice of the European Union (**CJEU**), and vi) the Court of Auditors, is one of the seven institutions forming the institutional framework of the EU.

[275] On the compliance by the SSM framework with EU constitutional provisions and the sufficiency of Article 127.6 of the Treaty on the Functioning of the European Union (**TFEU**) as legal basis, see Gren (2018); Lackhoff (2017), p. 155 ff.

[276] Within the SSM, a NCA is a public authority or body officially recognised by national law, which is empowered to supervise the banking sector as part of the broader financial system and it is mandated by national law to carry out the prudential supervisory tasks set out under the EU and national legal framework.

[277] As it was first put forward by Tommaso Padoa-Schioppa in the early 2000s, the 'single rulebook' for banking services envisages that key technical rules should be defined at the EU level and adopted through EU regulations, so that they are directly applicable to all financial institutions operating in the Single Market, without any need for national implementation or possibility for additional layers of local rules. More recently, a few months after the outset of the global financial crisis and the *Lehman* collapse in early 2009, the de Larosière Report stated that a single financial market in the EU cannot properly function if rules are significantly different from one Member State to another. The EU pre-crisis regulatory approach based on minimum harmonisation, coupled with the home-host cooperation, allowed national authorities to use the regulatory lever to favour national champions and attract business to national markets, thus weakening the overall regulatory framework and creating an uneven playing field. Therefore, in 2009, the term 'single rulebook' was put forward by the European Council in the context of the establishment of the ESFS that led to the creation, *inter alia*, of the European Banking Authority (**EBA**). The EU single rulebook aims at bringing about a unified regulatory framework for the EU banking sector that would complete the single market in banking services. In particular, to bring about a single rulebook in banking, the EC and the co-legislators have developed a three-pronged approach: i) turning EU Directives into EU Regulations, as the latter are directly applicable and help avoid the regulatory discrepancies across Member States that arise in the context of implementation of EU Directives, ii) further specifying highly technical aspects of EU primary banking legislation by regulatory technical standards (**RTS**) and implementing technical standards (**ITS**)

Article 2.9 SSMR defines the SSM as '*the system of financial supervision composed by the ECB and national competent authorities of participating Member States* […]'. From this definition, it follows that the SSM, like the European System of Financial Supervision (**ESFS**)[278], does not have legal personality. The choice of not creating a separate body and conferring on the ECB specific supervisory powers under Article 127.6 TFEU[279], was aimed at avoiding a delegation of powers to a

developed by the EBA, and iii) limiting the embeddedness of options and discretions (**ONDs**) in banking regulation, which are often to be implemented on a case-by-case basis by NCAs. In line with this framework, since 2010 the EBA has been tasked to develop technical standards to bring about a more comprehensive single rulebook in banking. In particular, the EBA, pursuant to the mandates provided in primary EU legislation in the meaning of Article 288 TFEU (usually EU banking legislative acts), is tasked to draft RTS and ITS and submit them to the EC for endorsement. Following the adoption by the EC pursuant to the procedure laid out in Articles 290 and 291 TFEU, RTS and ITS are published in the Official Journal of the European Union (**OJ**) as binding legal acts for their addressees. However, the centralisation to the EBA of regulatory production powers in banking implies, following the establishment of the SSM, the decoupling of supervision from regulation at the supra-national level, as the ECB lacks formal regulatory powers when acting as a supervisor of the Eurozone banking system. The separation of regulation – which is harmonised at EU level – and supervision – which is centralised in the euro area – may create problems to the extent that the single supervisor cannot create a prudential rulebook for the Eurozone, but is subject to EU prudential regulation and national law provisions, potentially limiting its supervisory discretion in an undue way. At the same time, however, the ECB as supervisor shall be entitled, or even expected, to communicate to supervised entities and the markets its supervisory expectations on policy matters through soft law and operational acts, which, even if formally non-binding, will likely have a strong effect towards harmonisation of banks' behaviours and business practices across the EU banking sector. On the rationale and *status quo* of the 'single rulebook' project for banking services, see Deslandes et al. (2019); Enria (2015). For an analysis of the relevance of the 'single rulebook' for the SSM, see Lefterov (2015). For a critical investigation of the role of the EBA in EU regulatory production and its limited effectiveness, see Ferran (2016).

[278] In response to the 2007-08 global financial crisis, the EC, in November 2008, tasked a High-Level Group to consider how EU financial supervision could be strengthened. The High-Level Group was chaired by Jacques de Larosière, former managing director of the IMF and former governor of the *Banque de France*. In its February 2009 report (the '**de Larosière Report**'), the Group urged EU Institutions to i) establish a EU-level body responsible for macro-prudential oversight of the European financial system, which would replace the Banking Supervision Committee (**BSC**) of the ECB established in 1998, and ii) transform the existing level 3 committees as part of the so-called Lamfalussy process (i.e. the Committee of European Banking Supervisors (**CEBS**), Committee of European Insurance and Occupational Pensions Supervisors (**CEIOPS**), and Committee of European Securities Regulators (**CESR**)) into three EU agencies entrusted with a broader mandate on financial regulatory production and a new responsibility to ensure that all national supervisors would faithfully implement and apply EU financial regulation, by being able to challenge their supervisory performance and to issue rulings to correct the shortcomings such agencies identify. The recommendations of the de Larosière Report were taken up by the EC, which outlined in a Communication dated May 2009 a new structure for EU financial supervision comprising two pillars: i) the European Systemic Risk Board (**ESRB**), responsible for monitoring and assessing potential threats to financial stability arising from macro-economic developments and from developments within the financial system as a whole (macroprudential supervision), and ii) three new European Supervisory Authorities (**ESAs**), namely the EBA, the European Securities and Markets Authority (**ESMA**) and the European Insurance and Occupational Pension Authority (**EIOPA**), responsible for drafting secondary EU-level financial regulation and working in parallel with a network of national financial supervisors to ensure the consistent application of EU supervisory standards, the soundness of individual firms and to protect consumers (microprudential supervision). Finally, the ESRB and the three ESAs, which form together with the ESAs' Joint Committee and the national supervisors the ESFS, were established in 2010 by way of four EU Regulations: Regulation (EU) No 1092/2010 of 24 November 2010 establishing the ESRB (the '**ESRB Regulation**'), Regulation (EU) No 1093/2010 of 24 November 2010 establishing the EBA, Regulation (EU) No 1094/2010 of 24 November 2010 establishing the EIOPA, and Regulation (EU) No 1095/2010 of 24 November 2010 establishing the ESMA.

[279] Article 127.6 TFEU reads: '*[t]he Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings*'. It is interesting to note that, unlike all the other tasks mentioned under Article 127 TFEU (e.g. implementation of monetary policy, contribution to the smooth operation of payment systems, etc.), Article 127.6 TFEU entrusts to the ECB itself, and not the European System of Central Banks (**ESCB**), the possible assumption of prudential supervisory tasks in respect of EU banks. It is difficult to imagine, however, how this inconsistency in technical language will have any concrete impact considering that the ESCB and ECB have the same ultimate decision-making bodies when it comes to banking supervisory tasks (see Chapter 2, Paragraph IV.).

new EU agency, subject to the strict limits of the CJEU's *Meroni* doctrine[280], and an unnecessary complication of the EU financial architecture. As a consequence, the supervisory decisions adopted by the European and national public institutions composing the SSM and exercising the supervisory powers embedded into the EU legislation implementing Basel III[281], cannot be ascribed to the SSM itself, but have to be imputed to the ECB or to the relevant NCA according to the rules on the distribution of competences contained in the SSMR[282]. In this regard, the ECB, as new European microprudential supervisory authority, is responsible within the SSM for the direct supervision of the largest Eurozone banks (referred to as '**significant institutions**', or '**SIs**')[283], which hold around 82% of total banking assets in the euro area[284], or around EUR 25 trillion[285], and for indirect supervision, through the NCAs, of all other banks (referred to as '**less significant institutions**', or '**LSIs**'). In particular, the SSMR centralises at the ECB the prudential supervision of significant i) credit

[280] Under the *Meroni* doctrine, a delegation involving '*discretionary power implying a wide margin of discretion which may, according to the use which is made of it, make possible the execution of actual economic policy*' would imply an illegal transfer of responsibility by replacing the choices of the delegator with those of the delegate and by altering the balance of powers thus doing away with the guarantee granted by the Treaty to undertakings. See CJEU, case C-9/56, (*Meroni & Co., Industrie Metallurgiche SpA v High Authority of the ECSC*), 13 June 1958, ECLI:EU:C:1958:7, p. 152. The *Meroni* judgment was issued in the context of the European Coal and Steel Community (**ECSC**) Treaty (not in force anymore) and concerned the validity of decisions of bodies established under Belgian private law adopted on the basis of a conferral of powers by the ECSC High Authority.

[281] Basel III was implemented in the EU in the form of one Regulation and one Directive, i.e. Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the '**CRR**'), and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (the '**CRD IV**'). In light of their high degree of regulatory interconnectedness, these two legal acts have been referred to in legal and economic scholarship as the 'CRD IV package'. However, not all Basel III standards were implemented in 2013 through the CRD IV package. Amendments to the EU banking supervisory regime became, therefore, necessary. Accordingly, the CRD IV package was recently amended by the 'CRD V package', i.e. i) Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (the '**CRR II**'), and ii) Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (the '**CRD V**'). The consolidated legal texts of the CRR and the CRD IV (which are still in force as they have been – substantially, in some parts – amended by the CRR II and the CRD V, but not repealed) currently embed the prudential rules to be applied by SSM authorities as well as non-Eurozone supervisors.

[282] See D'Ambrosio (2013), p. 29.

[283] The criteria that under the SSM determine the 'significance' of a bank are examined under Chapter 2, Paragraph 1.2.

[284] See Constâncio, ed., et al. (2019), p. 19. As at 1 October 2020, the Eurozone banking groups directly supervised by the ECB are 113, which correspond to roughly 1,000 banks at the individual level (including LSIs, this number raises to over 3,600 institutions). The list of supervised entities is updated by the ECB in the first week of every month and it is published on the ECB website.

[285] According to statistics elaborated by the BIS (cut-off date October 2020), total outstanding banking assets at the global level amount to around 92 USD trillions. See BIS (2020).

institutions[286], ii) financial holdings[287], iii) mixed financial holdings[288], and iv) branches established in a participating Member State by a credit institution which is established in a non-participating Member State[289] (together, the '**supervised entities**'[290]). Further, the ECB exercises its prudential tasks and powers towards 'central bodies'[291], even if they are not banks[292]. In this sense, the SSM, comprising the ECB and the national supervisory authorities, can be defined as a unique and unprecedented juxtaposition of European and national competences that includes several layers of supervisory implementation[293]. In a nutshell, these are:

1. exclusive competences of the ECB regarding the direct supervision of SIs;
2. oversight competences of the ECB over NCAs and indirect supervision over LSIs, including the power to give general instructions to NCAs and to take over supervision of a LSI to ensure the consistent application of high supervisory standards;
3. NCAs' exclusive supervisory competence over banks in relation to the tasks not transferred to the ECB[294], and also supervision of the financial institutions not within the supervisory scope of the SSM (such as asset management companies);

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[286] According to Article 4.1 No. (1) CRR, 'credit institution' means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account. From this definition it follows that the supervisory competences of the ECB do not extend to entities that carry out only one of these activities (i.e. either taking repayable funds or granting credit). Such entities are, for example, the financial intermediaries regulated under Article 106 of the Italian Consolidated Banking Law (*D.Lgs 1º settembre 1993, n. 385*), which can be authorized only to grant credit and not to take deposits and repayable funds from the public. For this narrow interpretation of the CRR, see Lackhoff (2017), p. 160.

[287] According to Article 4.1 No. (20) CRR, 'financial holding company' means a financial institution, the subsidiaries of which are exclusively or mainly institutions or financial institutions, and which is not a mixed financial holding company; the subsidiaries of a financial institution are mainly institutions or financial institutions where at least one of them is an institution and where more than 50 % of the financial institution's equity, consolidated assets, revenues, personnel or other indicator considered relevant by the competent authority are associated with subsidiaries that are institutions or financial institutions.

[288] According to Article 4.1 No. (21) CRR, 'mixed financial holding company' is defined by Article 2 (15) of Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council (the '**FICOD**'), which stipulates that a mixed financial holding company is a parent undertaking, other than a regulated entity, which, together with its subsidiaries – at least one of which is a regulated entity which has its registered office in the EU – and other entities, constitutes a financial conglomerate.

[289] Branches established in SSM Member States by credit institutions from third countries (such as the United States) or from the European Economic Area (such as Norway) do not fall within the scope of the SSM and remain subject to direct supervision by NCAs.

[290] Article 2 No (20) FR. Unless expressly specified otherwise, in the context of this work the term 'bank' or 'credit institution' refers to all four categories of financial institutions now directly supervised by the ECB.

[291] As defined by Article 10 CRR.

[292] There is a twofold reason for this: First, no plausible reason is apparent why central bodies that are credit institutions should be treated differently from central bodies that are not credit institutions. Second, if cooperative organisations that act unified would be excluded from a centralised supervision because of the central body not being a credit institution, financial holding or mixed financial holding this would not be in line with the objectives of the SSMR. See Lackhoff (2017), p. 138.

[293] See Texeira (2013), p. 83.

[294] Such as business conduct supervision and consumer protection, AML-CFT requirements and supervision of payment services. See Recital 28 SSMR.

4. shared and parallel competences among the ECB and NCAs regarding some supervisory tasks (notably, macroprudential supervision)[295] and the combination of both European and national competences to give effect to certain tasks, such as the imposition of sanctions[296].

In this Chapter, the organisational structure of the SSM, its decision-making processes, as well as the supervisory tasks and powers conferred to the ECB in relation to SIs and LSIs will be discussed. In particular, Paragraph I. deals with the governance architecture of the SSM, Paragraph II. and III. examine the supervisory tasks (and powers) that the ECB, as supervisory authority, carries out in respect of all Eurozone-based credit institutions and SIs, respectively, while Paragraph IV. explains the decision-making structure of the SSM and mechanisms to ensure the judicial protection of the addressees of ECB administrative acts.

1.1. Governance and structure of the SSM

The process to build the Banking Union is the most far-reaching reform of institutional harmonization and supervisory centralization within the Euro area since the creation of the euro[297]. The ECB-SSM carries out banking supervision from a European perspective, *inter alia*, by i) establishing a common approach to day-to-day supervision for the largest part of the Eurozone banking sector, ii) taking harmonised supervisory actions and corrective measures in a neutral way, and iii) ensuring the consistent application of regulations and supervisory policies to all supervised entities. Within the SSM framework, the ECB is the hierarchically superior and central authority that, in close cooperation with the NCAs, is responsible for ensuring that European risk-based banking supervision is carried out in an effective and consistent manner[298]. Accordingly, the ECB is

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[295] See Chapter 2, Paragraph 2.3.

[296] See Chapter 3, Paragraph IV.

[297] See Constâncio (2013).

[298] Following the establishment of the SSM in 2013, the ECB has then become the centre and focal point of two multi-layered administrative systems composed by the ECB itself and public authorities of Eurozone Member States, i.e. the SSM and the ESCB. Under Article 282 TFEU, a further distinction is put forward between the ESCB – as composed by the ECB and the National Central Banks (**NCBs**) of all EU Members States – and the Eurosystem – as composed by the ECB and the NCBs of the Member States whose currency is the euro. The exclusive competence in the field of monetary policy, as conferred by the Treaties to the EU, is conducted by the Eurosystem. This differentiation between two groups of EU Member States, determined by their relation to the euro as their currency, was officially constitutionalised by the Lisbon Treaty, which entered into force on 1 January 2009. Therefore, the ECB is currently entrusted with the challenging task, on the one hand, to perform monetary policy functions, as monetary authority at the centre of the ESCB and the Eurosystem, and, on the other, to carry out banking supervisory tasks, in its function as competent supervisory authority. To avoid possible conflicts of interests between ECB monetary and supervisory decision-making, and ensuring that both the monetary policy and the supervisory function are exercised autonomously in accordance with the applicable objectives, Article 25 SSMR enshrines the so-called 'principle of separation' between the two functions. In particular, Article 25 SSMR requires the ECB to ensure that supervisory tasks shall never interfere with monetary policy objectives (and vice-versa) and organise staff involved in carrying out these two separate tasks according to different reporting lines and subject to strict confidentiality regimes and limitations in the exchange of information. Within the SSM, this has been ensured by the establishment of seven dedicated Directorates General (**DGs**) in charge of microprudential supervision, which report functionally to the Chair and Vice-Chair of the Supervisory Board of the SSM, and are physically located in the city of Frankfurt am Main but in a separate ECB building than monetary policy. To follow-up on the provisions of Article 25 SSMR, the ECB laid down a detailed framework to ensure organisational separation and professional secrecy between its two functions. See Decision of the European Central Bank of 17 September 2014 on the implementation of separation between the monetary policy and supervision functions of the European Central Bank (ECB/2014/39) (2014/723/EU) (the '**Separation Decision**'). For an overview of the scholarly debate on the theoretical arguments in favour or against of the principle of separation, see Chapter 1, Paragraph 1.1.1.. For an analysis of the principle of separation as implemented in the case of the ECB, see Lackhoff (2017), pp. 78-81; Texeira (2013), p. 81 ff. For a comparison between the institutional set-up of the ESCB and the SSM, and how EU constitutional rules constraint the

responsible for ensuring the unitariness of the SSM and takes responsibility for its overall functioning[299]. In order to carry out supervisory tasks in an effective and independent manner, and also in light of the principle of separation, the SSMR has provided for the establishment of a new and independent ECB internal body in charge of proposing the adoption of draft supervisory decisions to the Governing Council (**GovC**), which remains the ultimate decision-making body of the ECB as set out under Article 129 TFEU and Protocol No 4 to the TFEU (the '**ESCB statute**'). This newly established body is the Supervisory Board (**SB**), which is composed by its Chair, the Vice-Chair, four ECB representatives and one representative from each NCA (usually the Head of the banking supervisory directorate/department). The GovC may adopt or object to the proposed SB supervisory decisions but cannot in principle modify them. Moreover, GovC deliberations on supervisory matters are kept strictly apart from those on other ECB functions, with separate agendas and meetings[300].

Following the establishment of the SSM, the ECB has become the focal point of a trans-national, or pan-European, banking supervisory safety net in which direct supervision of SIs, the decision-making in common procedures and the oversight of NCAs are centralised. Under this perspective, an important feature of the SSM is the two-faced functional relationship between the ECB and the NCAs, as the ECB, on the one hand, is placed on higher institutional grounds and is entrusted to adopt final decisions as regards the activation of most banking supervisory powers provided under EU prudential legislation, while, at the same time, it is influenced by the NCAs due to their collective contribution to SSM decision-making processes[301]. Therefore, the principle of cooperation in good faith applies to all supervisory activities[302]. Furthermore, to ensure the consistent application of prudential requirements and supervisory policies across all the EU Member States participating to the SSM, the SSMR provides the ECB with the power to, on the one hand, directly apply national provisions transposing EU Directives that grant supervisory powers to the relevant NCA[303], and, on the other, require NCAs by way of binding instructions to make use of their national powers vis-à-vis SIs (individually or collectively)[304] when the national legal basis of those powers does not derive from

decision-making processes and the operation of these two pan-European administrative systems (or mechanisms), see Gren (2018).

299 Article 6.1 SSMR.

300 For a detailed analysis of the decision-making processes of the SSM, see Chapter 2, Paragraph IV.

301 For instance, in the case of the so-called 'common procedures'. See Chapter 2, Paragraph 2.1.

302 The principle of cooperation in good faith, together with the legal obligation on all authorities composing the SSM to exchange information, is enshrined under Article 6.2 SSMR. The application of this principle implies that, for instance, the three SSM DGs in charge of direct supervision of SIs shall cooperate with the NCAs on a daily basis through the respective Joint Supervisory Teams (**JSTs**) (on the internal organization of the SSM and functioning of the JSTs, see Chapter 2, Paragraphs 1.1.1. and 1.1.2.). At the same time, to perform its oversight function and indirect supervision of LSIs, the SSM 'Specialised Institutions & LSIs' DG maintains close contact with the NCAs through a dedicated senior management network. On the other hand, the NCAs also contribute to the work of SSM horizontal and specialised divisions through various types of fora such as networks of experts. Furthermore, the SB may decide to establish working groups, composed of ECB and NCA representatives, to focus on specific horizontal topics and support the regulatory work of the ECB when the latter has to release public policy stances.

303 This power is expressly granted to the ECB by Article 4.3 SSMR. For a discussion on the scope and implications of this Article, see Chapter 2, Paragraph 3.3.

304 The ECB power to issue binding instructions to NCAs to make use of purely national supervisory powers applies in respect of microprudential powers. In case national law would classify a specific supervisory measure or tool as 'macroprudential', the ECB would not have at disposal such binding power as, within the SSM framework, macroprudential powers are allocated between the ECB and the national authorities according to a system of shared, or parallel, competences. Hence, with regard to purely national macroprudential tools (such as the imposition of a cap on the loan-to-value ratio for financing arrangements), the ECB may suggest to the relevant NCA to make use of its

EU banking legislation[305]. The NCAs must follow such instructions, even while the nature of their acts remains national[306]. From all aforementioned legal and institutional considerations, it can be safely drawn that the SSM cannot be classified as a mere cooperation arrangement between national and supra-national authorities where each of them retains entirely its margin of institutional autonomy and decision-making capacity. Rather, the establishment of the SSM brings as a consequence the partial surrender of sovereignty by Eurozone Member States over the conduct of banking (micro-) prudential supervision in favour of a EU Institution, which, pursuant to the principle of conferral as enshrined in the Treaties[307], has the power to adopt final decisions in relation to the largest part of the microprudential supervisory tasks set out under the CRD package and instruct national authorities through binding administrative acts to adopt (or not) a certain decision or behaviour that may be desirable or harmful, respectively, to the achievement of its supervisory mandate[308].

Importantly, in order to make the SSM operative, the SSMR envisages that the ECB shall enact several regulatory acts[309]. In particular, the main regulatory act that shall be enacted by the ECB is the framework mentioned by Article 6.7 SSMR. Such framework should comprise the methodology for determining whether a supervised entity has the status of SI or LSI, the procedure for determining this status (and its annual review), as well as rules on the cooperation between the ECB and the NCAs

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macroprudential powers, but the NCA would not have any legal obligation to follow ECB instructions. For an analysis of the EU-SSM macroprudential framework, see Chapter 2, Paragraph 2.3.

[305] Article 9.1 (3) SSMR.

[306] In line with language provided under Article 6.3 SSMR, the majority of legal scholars seems to agree that ECB instructions under Article 9.1 (3) SSMR are legally binding upon NCAs. See, among others, Lackhoff (2017), p. 39; Allegrazza and Voordeckers (2015), p. 152; D'Ambrosio (2013), p. 31. For a dissenting opinion in the literature, see Bassani (2019), pp. 123-126. However, the latter scholarly position does not seem to be convincing, and the own position is that the ECB power to instruct NCAs to make use of national supervisory powers that do not derive from EU law, as provided under Article 9.1 (3) SSMR, is legally binding upon NCAs. This is in line with the wording provided under Article 6.3 SSMR and the overall position of hierarchical supremacy that the ECB enjoys within the SSM framework as regards microprudential supervision.

[307] The principle of conferral is set out under Article 4.1 and 5.2 TEU. Such principle is the cornerstone of the EU mechanics according to which competences are allocated either with the national or the supranational level of administration. It states that competences that are not conferred upon the EU in the Treaties, remain with the Member States. Consequently, the EU can act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. In other words, the EU only has attributed competences. Prior to the Lisbon Treaty, the delimitation of competence between the EU and the Member States was not easy to specify with exactitude. Therefore, the Member States decided to make the principle of conferral concrete by including a catalogue of competences in the Lisbon Treaty, more specifically, in Articles 2 to 6 TFEU.

[308] Notwithstanding the centralisation to the ECB of supervisory powers in relation to the largest part of the microprudential subject matters included by the BCBS under the Basel framework, some commentators have provocatively argued that, due to the intrinsic relative importance of inter-institutional cooperation to its functioning, the '*SSM represents a system of semi-strong centralisation*'. See Ferrarini (2015), p. 57. However, even though the Council has ultimately decided not to follow the approach put forward by the EC in its legislative proposal, that implied the full transfer of direct supervisory tasks (and powers) in respect of all Eurozone banks (and not only SIs) to the supranational level, it seems unavoidable to acknowledge that risk-based prudential supervision of such a large and heterogeneous banking sector (also in geographical and linguistic terms) needs to be carried out in close cooperation between the ECB and the NCAs within a common supervisory framework. Furthermore, in light of the direct supervisory tasks and powers conferred to the ECB within the SSM, together with the power to instruct NCAs to adopt national supervisory decisions, apply national provisions implementing EU banking legislation, and regulate the internal governance structure and processes of the SSM (including the appointment of JSTs' members) with a view to ensuring its functioning, one can safely argue that the SSM, while not being a fully integrated pan-European administrative architecture like the ESCB, strongly leans towards a federal European model of banking supervision, in which the decentralised nodes of the system, i.e. the NCAs, grant assistance and expertise to the apex of the mechanism, i.e. the ECB, on various regulatory matters and, when needed, give effectiveness to supervisory decisions taken at the central supranational level into domestic systems.

[309] Article 4.3, 6.7, 30.2 and 33.2 SSMR.

in respect of the prudential supervision of both SI and LSIs. To follow-up on this provision, in April 2014 the ECB published the Framework Regulation (**FR**)[310], which contains 153 Articles over twelve Parts, and provides detailed rules on the i) organisational structure of the SSM, ii) exercise of cross-border activities, iii) administrative procedures, iv) the language regime, v) the close cooperation with non-pMSs, vi) sanctioning powers and vii) the exercise of investigatory and other powers. Due to its highly analytical content and multiple procedural provisions that largely contribute to a more efficient functioning of the SSM, the FR is '*the cornerstone of ECB's legislative acts in connection with the implementation of the SSM*'[311].

1.1.1. Internal governance of the SSM: The Directorates General…

In a bottom up view, the foundation of the organisational structure of the ECB with regard to its supervisory functions is formed by the JSTs[312], which carry out day-to-day supervision of SIs. JSTs are an integral part of the ECB internal architecture that consists of seven main DGs responsible for direct microprudential supervision, oversight of NCAs and indirect supervision of LSIs, horizontal functions and the common procedures. In this sense, DGs establish a SSM internal superstructure in which JSTs or relevant supervisory functions are embedded. Each DG is sub-structured in divisions (led by a Head of Division), which, in turn, are sub-structured in sections (led by a Head of Section). The existence and the organisational structure of DGs is not determined by the SSMR. Article 28 SSMR only stipulates that the ECB shall be responsible for devoting the necessary financial and human resources to exercise supervisory tasks. This formulates an objective but does not predefine the organisational structure, rather the ECB is free to determine it[313]. The Executive Board (**EB**)[314], as decision-making body in charge of managing the day-to-day business of the ECB, is the body also in charge of managing ECB staff and the internal organisational structure of the SSM[315]. The third intra ECB organisational layer in respect of the SSM is the SB. The SB is the body responsible for supervisory planning and the preparation of supervisory decisions addressed to supervised entities. In its role, it has a monopoly for proposing supervisory decisions to the GovC[316]. The SB is supported

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310 Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17). Additional documents that provide insights into the ECB approach to banking supervision are the *SSM Supervisory Manual* published in March 2018 and the *Guide to Banking Supervision* published in November 2014. For a complete overview of the legal acts adopted by the ECB to make the SSM operational, see Lackhoff (2017), pp. 4-9.

311 See Lackhoff (2017), p. 4.

312 See next Paragraph.

313 See Lackhoff (2017), p. 52.

314 According to Article 129 TFEU, the ESCB is governed by the decision-making bodies of the ECB, i.e. the Governing Council and the Executive Board. According to the statute of the ESCB, the EB consists of the ECB President, the ECB Vice-President and four other members chosen from among persons of recognised standing and professional experience in monetary or banking matters. All members are appointed by the European Council, acting by a qualified majority. The EB is responsible for i) preparing the GovC meetings, ii) implementing monetary policy for the euro area in accordance with the guidelines specified and decisions taken by the GovC (also through instructions to the euro area NCBs), iii) managing the day-to-day business of the ECB, and iv) exercising certain powers, also of regulatory nature, delegated to it by the GovC.

315 According to Article 3.2 Separation Decision, '*[a]ll work units of the ECB shall be placed under the managing direction of the Executive Board. The competence of the Executive Board in respect of the ECB's internal structure and the staff of the ECB shall encompass the supervisory tasks. The Executive Board shall consult the Chair and the Vice Chair of the Supervisory Board on such internal structure*'.

316 See Lackhoff (2017), p. 48.

by a Steering Committee that prepares the meetings of the SB. The DG SSM Governance & Operations supports the decision-making process. Finally, the GovC is the ultimate decision-making body of the ECB-SSM, but it may only act upon a complete draft decision provided to it by the SB and may only adopt or reject such complete draft decisions[317].

The ECB internal organisational structure to supervisory matters was originally determined by the allocation of competences within the SSM and the distinction between direct supervision of SIs and indirect supervision of LSIs. Indeed, since its establishment until the recent internal reorganisation that took place in July 2020, the SSM internal architecture was composed of four DGs for micro-prudential supervision, as complemented by the DG Secretariat to the Supervisory Board with the task to support the SSM decision-making processes[318]. On 29 July 2020, the ECB announced[319] the first set of wide-reaching reorganization efforts to the internal structure of the SSM since the SSM commenced its operations in November 2014[320]. The reorganisation builds on six years of experience in European banking supervision and aims at shifting the focus towards more risk-based supervision. In particular, the SSM reorganisation introduced two new DGs (or business areas) and amended certain SSM senior management positions[321]. These internal reorganisation efforts aim at further stepping up SSM supervisory scrutiny, also in respect of recent regulatory changes and new priorities within the SSM existing mandate. These include, among others, the accession to the EBU of two EU Member States, i.e. Bulgaria and Croatia[322], the outset of the Covid-19 pandemic, as well as the approval of the CRD V package, which lays out, among others, new requirements for financial holding companies and the approval of the new EU-wide regulatory and supervisory regime for investment firms[323], which will also add, from June 2021, to the ECB-SSM's supervisory responsibilities.

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[317] For a discussion of the SSM decision-making process with regard to microprudential supervision, see Chapter 2, Paragraph IV. The exercise by the ECB of macroprudential powers follows a different process, see Chapter 2, Paragraph 2.3.2.

[318] In particular, DGs Micro-Prudential Supervision I and II ('**DG-MS I**' and '**DG-MS II**', respectively) were to conduct the direct and day-to-day supervision of SIs through the JSTs. The division of responsibility for supervision between these two directorates followed a risk-based approach, which allowed them to specialise by risk exposure, complexity and business model of the banks. This resulted in a small number of the largest banks being supervised by DG-MS I and a much larger number being supervised by DG-MS II. DG Micro-Prudential Supervision III (**DG-MS III**) was in charge of the conduct of indirect supervision and regulatory work in respect of LSIs. DG Micro-Prudential Supervision IV (**DG-MS IV**) performed horizontal supervision and provided specialised expertise, such as supervisory quality assurance, methodology and standards development, crisis management, capital market risk analysis and model validation. Additionally, the Directorate General Secretariat to the Supervisory Board (**DG-SSB**) was composed of the Decision-Making Division, which supported the activities of the SB by assisting in drafting and reviewing supervisory decisions addressed to SIs, and related legal issues, and of three Divisions regarding authorisations, quality assurance and enforcement and sanctions, which offered horizontal functions to the SSM.

[319] See ECB press release dated 29 July 2020 '*ECB announces organisational changes to strengthen banking supervision*'. For a preliminary assessment of the ECB-SSM reorganisation, see Dentons (2020).

[320] The reorganizational changes have been implemented and made operational by end-2020.

[321] No announcements on amendments to the non-SSM organizational structure have been communicated as of yet but these may follow the outcomes from the ECB monetary policy strategic review announced by the new ECB President Ms. Lagarde in September 2020, which, however, has been delayed until at least mid-2021 due to the Covid-19 pandemic.

[322] As of 1 October 2020, the ECB directly supervises five SIs in Bulgaria and eight SIs in Croatia, following the establishment of a close cooperation with the NCAs of these countries. See Chapter 2, Paragraph 1.3.

[323] The EU new framework for investment firms is part of the efforts of the EC to strengthen the European Capital Markets Union (**CMU**) and is composed by the Investment Firms Regulation (**IFR**), i.e. Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014, and the Investment Firms Directive (**IFD**), i.e. Directive (EU) 2019/2034 of the European Parliament and of the Council of 27

The key amendment of the July 2020 SSM reorganisation is that supervised entities have been grouped under the same DG based on their business models. With this new approach, intended to complement the current one based on the significance criterion, the ECB-SSM aims to strengthen cooperation between bank-specific and thematic supervisory teams, reinforce the SSM supervisory strategy and risk function (i.e. the second line of defence) and ensure the consistency and predictability of supervisory actions. As mentioned, the organisational changes included the creation of two additional DGs – bringing the total to seven – and the redistribution of tasks across business areas. In particular, dedicated DGs have been established for key activities such as supervisory strategy and risk, on-site supervision, and governance and operations. More specifically, the July 2020 reorganisation established:

i. bank-specific supervision in three DGs structured to allow a better comparison of common risks and challenges. These are i) DG Systemic and International Banks (**DG/SIB**), DG Universal and Diversified Institutions (**DG/UDI**) and DG Specialised Institutions and Less Significant Institutions (**DG/SPL**)[324];
ii. dedicated horizontal supervision in the DG Horizontal Line Supervision (**DG/HOL**) to strengthen risk expertise in supervision and conduct benchmarking and industry-wide assessments (such as thematic reviews and maintain supervisory methodologies)[325];
iii. a supervisory risk function (second line of defence) in the DG Strategy and Risk (**DG/SSR**) to conduct strategic planning, propose supervisory priorities and ensure consistent treatment of all banks[326];
iv. a structurally independent on-site supervision function, i.e. DG On-site and Internal Model Inspections (**DG/OMI**)[327]; and

November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU. The IFR/IFD regime reshapes how investment firms and other firms with MiFID top-up permissions calculate their regulatory capital requirements and at what level these need to be maintained from June 2021. All firms in scope of the IFR/IFD need to fall within a specific class, based on their regulated activity but also within certain quantitative metrics in the form of 'K-Factors'. Systemically important and larger risky investment firms (i.e. Class 1) will be treated either as credit institutions and be held to the same rules under the CRD IV package. Those in the Eurozone will fall within the scope of the EBU and become subject to SSM (and SRM) supervision. All other investment firms (Class 2 and 3) in the EU-27 will become subject to the specific framework set out under the IFR/IFD package. Hence, they will not be subject anymore to the CRD package rules, as it was previously to the adoption of the IFR and IFD. Such framework includes a consolidated set of regulatory capital and liquidity requirements with limited waivers along with rules on internal models, governance, remuneration and disclosure. In-scope firms, in particular those in groups, will want to take prompt action well ahead of the June 2021 start date. In turn, the EBA, following the publication of a roadmap for the implementation of the new prudential regulatory for investment firms, has already started regulatory work to further specify EU level 1 prudential requirements by issuing for public consultation draft RTS and ITS covering, inter alia, the reclassification of certain investment firms to credit institutions, capital requirements for investment firms at solo level, as well as minimum requirements on concentration risk, liquidity, and disclosure. On the IFR/IFD reform package, see Kiss (2020).

[324] These three DGs take over the supervisory tasks previously assigned to DG-MS I, DG-MS II and DG-MS III. In particular DG/SIB and DG/UDI, together with Divisions 1 to 5 of DG/SPL, will likely be in charge of the on-going direct supervision of SIs through the JSTs, while the Institutional and Sectoral Oversight Division of DG/SPL will take over conduct of indirect supervision and regulatory work in respect of LSIs.

[325] DG/HOl takes over the majority of supervisory tasks previously assigned to DG-MS IV.

[326] DG/SSR takes over supervisory responsibilities from a number of Divisions previously part of DG-MS IV.

[327] DG/OMI grows from the Centralized On-Site Inspections Division previously part of DG-MS IV.

v. a stronger governance and operations function in the DG SSM Governance and Operations (**DG/SGO**) to support decision-making, and responsible for authorisations (such as fit and proper assessments and qualifying holding procedures) and innovation[328].

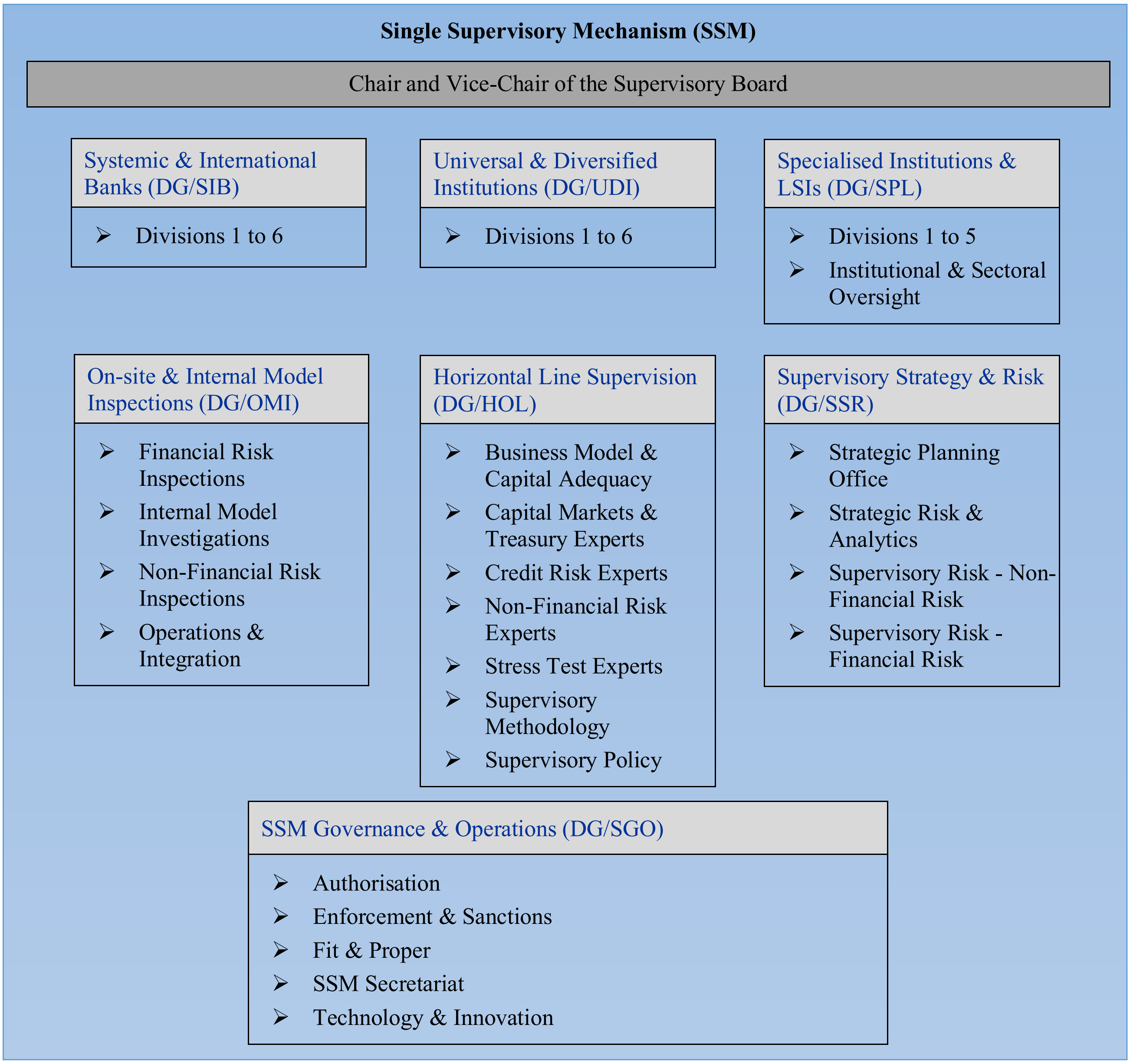

Figure 9. *Organisational structure of the SSM following the internal reorganisation in July 2020.*
Source: Author's illustration.

1.1.2. ... and the JSTs

As mentioned, the foundation of the organisational structure of the ECB with regard to its supervisory functions is formed by the JSTs, which carry out day-to-day supervision of SIs and are embedded into DG/SIB, DG/UDI and DG/SPL[329]. As the JSTs are the organisational structure by

[328] DG/SGO takes over the supervisory responsibilities previously assigned to DG-SSB.
[329] JSTs carry out their day-to-day direct supervisory functions by, *inter alia*, i) analysing the supervisory reporting, financial statements and internal documentation of supervised entities, ii) holding regular and *ad hoc* meetings with the

which the ECB handles its supervisory tasks in respect of SIs, whether the JSTs function smoothly and efficiently is a decisive factor for the success of the ECB as supervisor. The establishment, structure and fundamental operational principles of the JSTs are set out under the FR[330]. JSTs are 'hybrid' administrative units as they comprise staff from both the ECB and the NCAs of the countries in which the relevant SI (including its banking subsidiaries or significant cross-border branches) are established[331]. The ECB is in charge of the establishment and composition of the JSTs but the NCAs are responsible for the appointment of the national members[332]. Upon request of the ECB, the NCA is obliged to change one or more members it appointed[333]. One JST is established for each SI at the highest level of consolidation.

The size, overall composition and organisation of a JST can vary depending on the nature, complexity, scale, business model and risk profile of the supervised entity. To perform their direct supervisory function, JSTs may carry out also informal supervisory activities, as this results to be inevitable from the daily contact with the supervised entities (for instance, in the form of oral exchanges, conference calls, e-mail exchanges but also letters signed by the JST coordinator or senior management of the relevant DG). The common feature of such activities, which are referred to as 'operational acts' when manifested in a letter, is that they are not adopted through the formal decision-making process of the SSM, that is the non-objection procedure[334]. Therefore, operational acts do not have the form of a ECB legal act or administrative decision but represent non-binding recommendations. Nevertheless, as in national banking supervision, a substantial part of EU banking supervision is inevitably carried out in this informal manner[335].

Each JST is led by a coordinator, who shall be a staff member of the ECB[336] and who shall not come from the country where the SI is established[337]. JST coordinators are appointed for a period of three to five years, depending on the risk profile and complexity of the credit institution. The members of the JST appointed by the NCA, who remain civil servants of the relevant NCA, are obliged to follow the instructions of the JST coordinator with regard to their tasks in the JST[338]. The JST coordinator is responsible for the implementation of the supervisory tasks and activities as included in the Supervisory Examination Programme (**SEP**) developed for each SI[339]. In addition, JSTs may have a sub-structure. As mentioned, each NCA that appoints more than one member for a JST has to

supervised entities at various levels of staff seniority, iii) conducting ongoing risk analyses and ongoing analysis of approved risk models, and iv) analysing and assessing supervised entities' recovery plans. See ECB (Nov 2014) p. 30.

330 Articles 3 to 6 FR.

331 For example, if a SI headquartered in Germany has a subsidiary in Spain and another one in Italy and a branch that is significant (in the meaning of Article 51 CRD IV) in Austria, the JST includes members from Germany, Spain, Italy and Austria, and the members from each of these countries are coordinated by one JST sub-coordinator from each of the relevant NCAs involved. See Lackhoff (2017), p. 48

332 Article 4.1 FR.

333 Article 4.3 FR.

334 See Chapter 2, Paragraph IV.

335 See Lackhoff (2017), p. 51.

336 Article 3.1 (2) FR.

337 See ECB (Nov 2014), p. 17.

338 Article 6.1 FR. As JSTs members appointed from NCAs usually continue to work from their respective NCA's premises (unless stationed on a rotational basis at the ECB premises in Frankfurt am Main for a certain period of time), day-to-day work and coordination is achieved through IT communication channels and shared information systems.

339 The institution-specific SEP is developed by each JST for the SI it supervises based on a strategic planning carried out by DG/HOL outlining the strategic priorities and the focus of the supervisory work for a time period of 12 to 18 months. The SEP includes on-site inspections, reviews of internal models, the annual supervisory review and evaluation process and ongoing supervisory priorities. See ECB (Nov 2014), p. 30.

appoint a JST sub-coordinator[340]. NCAs' sub-coordinators are usually responsible for clearly defined thematic or geographic areas of supervision. Additionally, they support the JST coordinator in the day-to-day supervision of the relevant SI by ensuring the efficient contribution of the members of the JST appointed by their NCA[341].

In the case of JSTs comprising a significant number of supervisors (as expected to be the case within DG/SIB), the activities of the JST will be steered by a 'core-JST', consisting of the JST coordinator and the NCAs' sub-coordinators[342]. The core-JST organises the allocation of tasks among JST members, prepares and revises the SEP and monitors its implementation. It also reviews the consolidated risk, capital and liquidity assessments. In such a case, sub-teams for business model analysis, credit risk, governance and risk management, liquidity risk and market risk may be established[343]. Due to the combination of such unique features, JSTs are one of the most advanced examples within the broader EU institutional framework of a composite, pan-European public administration, and one of the most integrated and resourceful tool at disposal of the ECB as supranational supervisor. Under this perspective, as recognised by the EC, JSTs represent a genuine form of multi-national supervisory cooperation that, during the first years of functioning, has proved to be functional and credible, doing most of the groundwork for supervisory decisions[344].

1.2. Which banks are directly supervised by the ECB? The determination of the 'significance' status

As of 4 November 2014, the ECB directly supervised those credit institutions deemed 'significant' under the SSM. Credit institutions may be deemed significant on a stand-alone basis (in case the bank is not part of a group), or they may be deemed significant as they are included within a group where at least one credit institution is considered to be significant (i.e. all supervised entities belonging to a group are either significant or less significant)[345]. As each credit institution within the Eurozone is directly supervised by either the ECB or the NCAs, significance is the criterion to determine the competent supervisory authority within the SSM framework[346]. The SSMR provides for five criteria

[340] Article 6.2 FR.
[341] For certain tasks with a specific thematic focus, or tasks where particular technical expertise is needed, the JST may require additional support from the horizontal and specialised expertise ECB-SSM business areas, such as DG/HOL or DG/SGO.
[342] ECB (Nov. 2014), p. 15.
[343] See Lackhoff (2017), p. 50.
[344] See EC (2017) p. 9.
[345] Article 40.2 FR.
[346] In the context of this work, the term 'significant supervised entity' or 'significant credit institution' also refers to the concept of 'significant supervised group', unless expressly specified otherwise.

for determining whether a supervised entity or group[347] is significant[348]: i) size, ii) importance for the economy of the Union or any EU Member State participating to the SSM (**pMS**), iii) significance of cross-border activities, iv) the request for or receipt of public financial assistance directly from the ESM, and v) the fact that it is one of the three most significant credit institutions in a pMS (collectively, the '**significance criteria**'). Only supervised entities established in any pMS can be deemed significant by the ECB. In addition, the significance is determined for a supervised group at the highest level of consolidation[349], with all members of a group being either significant or less significant, and the significance assessment remains stable, in principle, for at least three years[350]. The only exception to the 'three years rule' may be made in cases of exceptional circumstances because of substantial changes in the operation of the SI[351], such as in the case of a merger or sale of business, which immediately affect compliance with the significance conditions by the relevant SI. It is also important to mention that the highest level of consolidation (i.e. including parent holding companies) must be determined within the SSM only. Therefore, if for example a credit institution (A) is established in a non-pMS and it holds three separate banks as subsidiaries (A1, A2 and A3) within the SSM, no supervised group with the highest level of consolidation within the SSM exists. In such a case, A1, A2 and A3 have to be assessed on individual basis[352].

As discussed, a SSM credit institution is deemed to be significant if it meets, at the highest level of consolidation[353], one of the following five conditions based on total assets:

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[347] A supervised group is defined by Article 2.1 No (21) FR as either a i) group whose parent undertaking is a credit institution or financial holding company that has its head office in a participating Member State, ii) a group whose parent undertaking is a mixed financial holding company that has its head office in a participating Member State, provided that the coordinator of the financial conglomerate, within the meaning of FICOD, is an authority competent for the supervision of credit institutions and is also the coordinator in its function as supervisor of credit institutions, or iii) supervised entities each having their head office in the same participating Member State provided that they are permanently affiliated to a central body which supervises them under the conditions laid down in Article 10 of Regulation (EU) No 575/2013 and which is established in the same participating Member State. While the first two cases for the existence of a supervised group refer to factual situations, the third criterion refers to structures where credit institutions are affiliated to a central body (which may be a bank but is not necessarily one) that is often owned by the affiliated credit institutions (these structures are particularly common in the cooperative sector). See Lackhoff (2017), p. 141.

[348] Article 6 SSMR and Article 39 FR.

[349] According to Article 18 CRR, the prudential perimeter of consolidation (which is different from the accounting perimeter of consolidation) includes credit institutions, financial holding companies, mixed financial holding companies, investment firms, financial institutions and ancillary service undertakings. Therefore, the assessment of significance shall be based (in the case of size) on the year end consolidated prudential reporting on own funds requirements under Article 99 CRR.

[350] In order to avoid that the competence for supervision changes on a continual basis within a short period of time, the FR introduced a 'stability rule' which is also referred to as the 'three years rule' (Article 47 FR). According to this rule, banks that are significant because of the application of (a) the size criterion, (b) the economic importance criterion, or (c) the significance of cross-border activities criterion may be classified as less significant if none of these criteria is met for three consecutive years. In addition, banks that are significant because of the public assistance criterion may be determined no longer significant, only three years after (a) the repayment of the public assistance it was granted, and (b) only three years after the termination of the public assistance if it was only applied for or promised. Last, in the case of a supervised entity that has been classified as significant because it is one of the three most significant credit institutions in a pMS, that bank may be re-classified as less significant if for three consecutive years it has not been one of the three most significant credit institutions in a pMS.

[351] Article 52.3 FR.

[352] Article 42 FR.

[353] With regard to the one of the three most significant banks of a pMS criterion, the highest level of consolidation is not the highest level of consolidation within the SSM but within the relevant pMS.

a) the value of its assets exceeds EUR 30 billion[354];
b) the value of its assets exceeded both EUR 5 billion and 20% of the GDP of the pMS in which it is located[355];
c) the bank is among the three most significant banks of the pMS in which it was located[356];
d) the bank has large cross-border activities[357]; and
e) the bank receives financial assistance from the ESM.

The significance status based on the size criterion (which is relevant also for the application of all the other significance criteria, with the exception of the financial assistance criterion) is reviewed annually[358] and may be reviewed by the ECB at any time after receiving relevant information[359]. Under a procedural perspective, the FR distinguishes between the ECB decision that determines the significance (or the end of the significance status) of a credit institution[360], and the take-over decision, by which the ECB communicates to the SI or LSI that as of a specific date ECB direct supervision will end or start, respectively[361]. Both decisions can be combined in one ECB supervisory decision.

On 4 September 2014, the ECB published its first final list of SSM banks determined to be significant and that it would directly supervise as of 4 November 2014. Based on updated data, as at 1 October 2020, the ECB directly supervised 113 banking groups in 21 pMSs, which collectively correspond to around 1,000 banks at the individual level (including LSIs, the number raises to over 3,600 institutions) and represent around 82% of total banking assets in the Eurozone. Direct day-to-

354 Pursuant to Article 53.2 FR, the NCAs (including the ECB) shall calculate the size of a group including, in addition to the entities included within the prudential perimeter of consolidation under Article 18 CRR, also the subsidiaries and branches in non-pMSs and third countries. As mentioned, the size assessment be based on the year end consolidated prudential reporting on own funds requirements under Article 99 CRR. Should these data not be available, the total value of assets shall be determined on the basis of the most recent audited consolidated annual accounts prepared in accordance with the IFRS as applicable with the EU in accordance with Regulation (EC) No 1606/2002 and, if such annual accounts are not available, the consolidated annual accounts prepared in accordance with applicable national accounting laws.

355 A credit institution may not only be relevant for the economy of a pMS if the aforementioned ratio between total assets and GDP is exceeded. Article 6.4 third sub paragraph (iii) SSMR shows that also in other situations the criterion of relevance for the economy of a pMS may be satisfied, thus justifying direct supervision by the ECB. According to this provision, a bank may be deemed significant if, following a notification by its NCA that it considers such an institution of significant relevance with regard to the domestic economy, the ECB takes a decision confirming such significance following a comprehensive assessment by the ECB, including a balance-sheet assessment, of that credit institution. The SSMR does not mention any criteria according to which this assessment shall be carried out. As noted in the literature, from the wording of Article 6.4 SSMR it is even possible that a bank with total assets below EUR 5 billion can be determined to be significant as this provision does not require such threshold to be met. Consequently, Article 57 FR has developed additional criteria including i) the significance of the supervised entity or supervised group for specific economic sectors in the Union or a pMS, ii) the interconnectedness of the supervised entity or supervised group with the economy of the Union or a pMS, iii) the substitutability of the supervised entity or supervised group as both a market participant and client service provider, and iv) the business, structural and operational complexity of the supervised entity or supervised group. On this residual significance criterion, see Lackhoff (2017), p. 148.

356 According to Article 65.2 FR, for the purposes of identifying the three most significant credit institutions or supervised groups in a pMS, the ECB (and the relevant NCA) shall take into account the size of the supervised entity and supervised group, respectively.

357 Article 6.4 3rd subparagraph SSMR reads: '*[t]he ECB may also, on its own initiative, consider an institution to be of significant relevance where it has established banking subsidiaries in more than one participating Member States and its cross-border assets or liabilities represent a significant part of its total assets or liabilities subject to the conditions laid down in the methodology*'. Article 59.2 FR specifies that the ratio of cross-border assets or liabilities to total assets or liabilities, respectively, must exceed 20% and establishes a minimum total value of assets amounting to EUR 5 billion.

358 Article 43.1 FR.

359 Article 43.2 FR.

360 Article 44.2 FR.

361 Article 45 FR.

day supervision and exercise of supervisory powers in respect of all other banks subject to the SSM – those deemed 'less significant' – is delegated to the NCAs of the respective pMSs in which the banks are located[362]. NCAs would continue to supervise these entities but would apply a harmonized regulatory regime, i.e. the single rulebook. The ECB, however, retains final supervisory authority over these banks and might, at any time, assume a direct supervisory role on its own initiative, or on the request of a NCA, to ensure consistent application of high supervisory standards[363]. In addition,

[362] The first CJEU case-law on the allocation of competences within the SSM seemed to imply a substantial strengthening of the ECB supervisory prerogatives within the SSM and of its higher hierarchal position vis-à-vis NCAs. Reference is made here, in particular, to the CJEU judgment on the legal proceeding initiated by the German bank *Landeskreditbank Baden-Württemberg – Förderbank* (**L-Bank**) against the ECB, following the classification of the bank as SI by the ECB in September 2014. L-Bank resisted being submitted to the ECB's supervision and decided to challenge in court the ECB supervisory decision that was notified to it and stipulated its significance, notwithstanding the fact that L-Bank assets exceed EUR 30 billion. L-Bank argued that the ECB erred in law in its decision to classify the bank as SI on the basis of two main arguments. First, the ECB incorrectly did not resort to the application of Article 70 FR, which allows the ECB to deal with cases of over-inclusion and, under particular circumstances, reclassify a bank that meets the size criterion (such as L-Bank), or the relevance for the economy criterion, or the three most significant institutions criterion, as LSI in order to better meet the objectives of the SSMR. Second, the ECB incorrectly incorporated in its assessment the principles of proportionality and subsidiarity, as the objectives of the SSMR could have just been as well attained through direct supervision by German supervisory authorities, without having to resort to direct supervision by a European Institution. In its judgment dated 8 May 2019, the CJEU rejected both arguments and confirmed the classification of L-Bank as significant, due to the uncontested fact that the bank met one of the SSMR significance criteria. However, L-Bank managed to escape ECB supervision through different means eventually. The CRD V, published in the OJ on 7 June 2019, introduced an exemption from the application of CRD provisions for all promotional banks in Germany (*Kreditanstalt für Wiederaufbau*). Under German banking law, these are bodies recognised as non-profit housing undertakings which are not mainly engaged in banking transactions. As L-Bank is classified as promotional bank under German law, as of 27 June 2019 L-Bank (and its German peers) are no longer subject to ECB direct supervision, in accordance with Article 2.5 CRD IV and Article 1 SSMR. Nonetheless, the exempted promotional banks continue to be governed by CRR rules. There is, however, a far more interesting aspect in the CJEU decision on the L-Bank case, which has been largely debated by legal scholars. In its judgment, the CJEU provided seminal clarifications on the functioning of the SSM and how the allocation of competences between the European and national level should be interpreted therein. In particular, the CJEU affirmed that the SSM framework has conferred to the ECB the '*exclusive competence*' with regard to all the tasks mentioned under Article 4.1 SSMR, '*the decentralised implementation of which by the national authorities is enabled by Article 6 of that regulation, under the SSM and under the control of the ECB*' (para. 49). Accordingly, '*[t]he national competent authorities thus assist the ECB in carrying out the tasks conferred on it by Regulation No 1024/2013, by a decentralised implementation of some of those tasks in relation to less significant credit institutions, within the meaning of the first subparagraph of Article 6(4) of that regulation*'. Under this perspective, the General Court, in its judgment dated 16 May 2017, was even more candid, as it plainly stated that '*under the SSM the national authorities are acting within the scope of decentralised implementation of an exclusive competence of the Union, not the exercise of a national competence*' (para. 72). The two judgments have been largely debated by legal scholarship, as the CJEU seemed to interpret the SSM framework as a fully centralised administrative system under which supervision of both SIs and LSIs (regardless of their significance) is entrusted to the supranational level, which, in turn, merely delegates to the national level the carrying out of prudential supervisory functions in respect of LSIs. Under this reading of the SSM framework, therefore, the ECB, and not the NCAs, would, in principle, retain the power to supervise LSIs, while such power would be delegated to the NCAs and exercised by them only due to operational purposes and the complexity of Eurozone banking markets. Whether this first interpretation of Article 6.4 SSMR by the CJEU, strongly leaning towards a fully centralised administrative model of banking supervision, will stand future legal challenges, it remains to be seen. See CJEU, Case C-450/17 P (*Landeskreditbank Baden-Württemberg v ECB*), 8 May 2019, ECLI:EU:C:2019:372; General Court, Case T-122/15 (*Landeskreditbank Baden-Württemberg v ECB*), 16 May 2017, ECLI:EU:T:2017:337. For some critical considerations on the CJEU and General Court's judgments in the literature, see Annunziata (2020); Smits (2017).

[363] See Article 6.5 (b) SSMR and Articles 67 to 69 FR. Article 6.5 (b) SSMR has been applied by the ECB with regard to the Latvian LSI *AS PNB Banka*, following a request by the Latvian national supervisory authority (i.e. the Latvian Financial and Capital Market Commission). On 11 March 2019, the ECB announced that *AS PNB Banka* were to be re-classified as significant (even if the bank did not meet any of the significance criteria) and the ECB assumed its direct supervision as of 4 April 2019. See ECB press release dated 11 March 2019 '*ECB takes over direct supervision of AS PNB Banka in Latvia*'. When a LSI is re-classified to SI, a JST is *ad-hoc* created and ECB direct supervisory powers apply. On 14 May 2019, *AS PNB Banka* challenged the ECB take-over decision before the CJEU, arguing that the ECB incorrectly interpreted and applied Article 6.5 (b) SSMR and failed to take into account the exceptional nature of this

a LSI can become subject to direct supervision by the ECB at any time due to an acquisition or merger of assets, or through organic growth, which caused it to satisfy the definition of significant.

1.3. The close cooperation arrangement

As mentioned, the EBU is a financial safety net for banking supervision and resolution that applies to the Euro area. As a EU bank directly or indirectly supervised by the ECB will automatically fall also under the remit of the European rules on resolution[364] as enforced by the Single Resolution Board (**SRB**) within the second pillar of the EBU, i.e. the Single Resolution Mechanism (**SRM**), the SSM defines the scope of operation of the Banking Union[365]. In this sense, the SSMR defines a EU pMS as '*a Member State whose currency is the euro or a Member State whose currency is not the euro which has established a close cooperation in accordance with Article 7*'[366]. From this definition, it follows that the EBU is an institutional architecture at variable geometry, as the SSMR leaves open the possibility for EU non-pMS to accede the EBU[367]. Yet, the concept of close cooperation does not envisage an accession of a non-pMS to the SSM so that it would step into the same position as pMS. Rather, the concept of close cooperation is based on the legal constraint[368] that supervisory acts of the ECB cannot apply in a non-pMS and that they have to be made binding through the NCA of that

provision. As at December 2020, the case is still pending before the General Court. On 15 August 2019, however, the ECB declared *AS PNB Banka* failing or likely to fail due to persisting capital shortfalls that lasted since end-2017 and made the bank operating in breach of CRR minimum capital requirements. See ECB press release dated 15 August 2019 '*ECB has assessed that AS PNB Banka in Latvia was failing or likely to fail*'.

[364] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (the so-called Bank Recovery and Resolution Directive, or the '**BRRD**'), as amended, among others, by Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC (the '**BRRD II**'). The BRRD implements within the EU the FSB Key Attributes as global benchmark to recovery and resolution of banks. See Chapter 1, Paragraph 3.2.

[365] An important feature of the set of regulatory reforms implemented by EU policy-makers since the outset of the 2007-08 global financial crisis, or even, in fact, since the introduction of the single currency as third phase of the EMU in 1998, has been that such reforms are characterised by variable geometry, as they may either apply to all EU Member States, or alternatively only to a sub-set of them, namely those Member States who have adopted the euro as their currency (currently, 19 EU countries out of 27). In this sense, to describe the current EU financial and monetary architecture, one could resort to the image of two concentric circles, the outermost of which would include regulations that are applicable in all EU Member States, while the innermost would include specific regulatory regimes applicable only to Eurozone countries. As a consequence of this increasing institutional and regulatory dichotomy between the EU in its entirety and the Euro area, the concept of 'multi-speed Europe' or 'two-speed Europe' emerged in legal and economic scholarship. Indeed, the EMU has been described as the '*first comprehensive experiment on differentiated integration*' within the EU. See Allemand (2015), p. 305. Under this perspective, one can place within the outermost regulatory circle, applicable to all EU Member States, the founding regulations of the authorities composing the ESFS, the CRD package, the EFSM and the BRRD. On the other hand, the innermost circle, applicable only to those EU Member States who acceded to the third phase of the EMU, would include the first two pillars of the EBU (i.e. the SSM and the SRM), the ESM and the 'two-pack legislation', which aims at further strengthening the application of the European Stability and Growth Pact within the Eurozone (for instance, through the establishment of the European semester and the legal obligation for Eurozone countries to submit their draft budgetary laws to the EC for examination). For an overview of the scholarly debate on differentiated economic integration within the EU, see Fabbrini (2016). For a legal analysis of the control measures of national budgets by EU Institutions, see Smits (2015); Seyad (2015). Finally, for a discussion of the ECB role between the euro area, the SSM and the EU, see Allemand (2015).

[366] Article 2 No. (1) SSMR.

[367] After all, the SSMR, being a EU Regulation in the meaning of Article 288 TFEU, is directed to all EU Member States and applies to all of them.

[368] See Article 139.2 (e) TFEU.

jurisdiction[369]. Supervision in close cooperation is thereby an indirect exercise of supervisory powers by the ECB through specific instruction to the NCA of the requesting EU Member State[370]. In substance, however, Eurozone-established SIs and the ones established in the requesting jurisdiction would find themselves in a comparable position and subject to the same supervisory requirements[371]. As for the rest of EU non-pMSs, the ECB and the respective NCAs will conclude a memorandum of understanding (**MoU**) describing how they intend to cooperate in the course of their supervisory tasks[372].

Close cooperation shall be established through an ECB decision that has to be adopted through the non-objection procedure[373], if certain conditions are met[374]. If following the establishment of close cooperation, the new pMS stops fulfilling the conditions laid out by the SSMR, the ECB may decide to suspend or terminate the close cooperation with that Member State[375]. Similarly, the new pMS may request the ECB to terminate the close cooperation at any time after a lapse of three years from the date of the publication in the OJ of the ECB decision to establish the close cooperation[376]. At present, 2 EU non-Eurozone jurisdictions decided to establish close cooperation with the ECB with the aim at joining the SSM, i.e. Bulgaria and Croatia. As of 1 October 2020, the ECB directly supervises five banks in Bulgaria and eight banks in Croatia, after having completed the significance assessment[377], the asset quality review and the stress test of the banking sectors of the two new pMSs[378]. As of the same date, the ECB is also responsible for the oversight of LSIs and in charge of the common procedures[379] for all supervised entities in the two countries. As a consequence, the EBU and SSM's scope currently extends to 21 jurisdictions, while the Euro area remains composed of 19 EU Member States[380].

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[369] Article 7.2 (c) and 7.4 SSMR.

[370] For an opinion in the legal doctrine raising fundamental concerns on the compatibility of the SSMR close cooperation procedure with EU constitutional law, see Dumitrescu-Pasecinic (2019).

[371] See Lackhoff (2017), p. 228.

[372] The ECB will also sign a dedicated MoU with the NCA of each EU Member State that is home to at least one G-SIB.

[373] See Chapter 2, Paragraph IV.

[374] Article 7.2 SSMR requires the acceding EU Member State to i) ensure that its NCA (and national designated authority) will abide by any guidelines or requests issued by the ECB, ii) provide all information on the credit institutions established within its jurisdiction that the ECB may require for the purpose of carrying out a comprehensive assessment of those credit institutions, and iii) adopt relevant national legislation to ensure that its NCA will be obliged to adopt any measure in relation to credit institutions requested by the ECB. The procedural aspects to establish close cooperation and the information to be provided by the non-pMS to the ECB are further described in the Decision of the European Central Bank of 31 January 2014 on the close cooperation with the national competent authorities of participating Member States whose currency is not the euro (ECB/2014/5) (2014/434/EU).

[375] Article 7.5 SSMR.

[376] Article 7.6 SSMR.

[377] See Chapter 2, Paragraph 1.2.

[378] According to the ECB, four of the six Bulgarian banks covered by the 2020 comprehensive assessment – *UniCredit Bulbank AD*, *DSK Bank EAD*, *United Bulgarian Bank AD* and *Central Cooperative Bank AD* – do not face any capital shortfalls, as they did not fall below the relevant thresholds used in the asset quality review and stress test. In contrast to these banks, *First Investment Bank AD* fell below the 8% CET1 ratio threshold for both the asset quality review and the stress test's baseline scenario, as well as fell below the 5.5% CET1 ratio threshold used in the stress test's adverse scenario. Last, *Investbank AD* fell below both the 8% CET1 ratio threshold used in the stress test's baseline scenario and the 5.5% CET1 ratio threshold used in the stress test's adverse scenario. On the other hand, the 2020 comprehensive assessment for the Croatian banking sector showed that the five Croatian SIs do not face any capital shortfalls as they did not fall below the relevant thresholds used in the AQR and the stress test. See ECB press release dated 11 September 2020 '*ECB lists Bulgarian and Croatian banks it will directly supervise as of October 2020*'.

[379] See Chapter 2, Paragraph 2.1.

[380] As noted by the Legal Service of the Council, the establishment of close cooperation between the acceding Member State and the ECB can be required as a condition for participation also in the Exchange Rate Mechanism II (**ERM II**),

In light of the establishment of the EBU and the concrete application of the close cooperation arrangement, one may argue, through a re-elaboration of the ‘two-speed Europe’ concept recently introduced by legal scholarship, that ‘three-speed Europe’ may actually be the more appropriate paradigm to describe the current multi-faced and liquid EU institutional framework, as the EU, the EBU and the Eurozone have all different memberships and regulatory regimes. Under this perspective, importantly, participation in the SSM through close cooperation implies a change in the supervisory and resolution framework, but does not have implications for the monetary policy operational framework. Therefore, Bulgarian and Croatian banks, while being supervised by the ECB, in principle will not have access to ECB emergency liquidity lines in case of a systemic liquidity crisis[381].

bearing in mind the link between the EBU and financial stability and the clear connection between the triad of banking systems, public budget and monetary policy. This is particularly relevant as, in addition to joining the EBU, on 10 July 2020 Bulgaria and Croatia also joined the ERM II as part of the countries’ efforts to join the euro area and adopt the single currency. See Council (2019).

[381] The task of a Lender of last resort (**LOLR**) is to provide liquidity to the banking system in case of a systemic liquidity crisis. The ESCB statute and the operational framework of the ECB do not contain any formal reference to the LOLR function. However, it can be argued that the ECB, by providing unlimited liquidity against good collateral, and arguably at a penalty rate, since October 2008, acted as a *de facto* LOLR for the whole banking system of the Euro area. Notwithstanding the legal and institutional constraints, whether it will be really possible for the ECB, in light of its supervisory mandate to ensure the soundness of the banks it supervises, to exclude Bulgarian and Croatian banks from emergency liquidity lines in case of an idiosyncratic systemic liquidity crisis, it remains to be seen. For a discussion of the LOLR function that the ECB *de facto* assumed since the outbreak of the GFC, see Garcia-de-Andoain et al. (2016). In particular, the Authors identified two main effects of ECB emergency liquidity provision on interbank markets. First, central bank liquidity replaced the demand for liquidity in the interbank market, especially during the financial crisis (2008-2010). Second, it increased the supply of liquidity in the interbank market in stressed countries (Greece, Italy and Spain) during the sovereign debt crisis (2011-2013).

II. Supervisory Tasks and Powers Relating to All Supervised Entities

2.1. The common procedures

According to the allocation of competences under Article 6 SSMR, the ECB is, in principle, the competent supervisory authority only for SIs. However, in deviation from this rule, the ECB can exercise investigatory powers in relation to both SIs and LSIs[382], as well as its macroprudential powers relate to all Eurozone banks[383]. Furthermore, the ECB is also involved in the process for making use of the EU-passport for all credit institutions[384].

Most significantly, the ECB is also exclusively competent to exercise certain supervisory tasks, which fall under the name of 'common procedures'[385], in respect to *all* banks established within the Eurozone. These tasks pertain to i) the granting of the authorisation as credit institution, ii) the withdrawal of the authorisation, and iii) the assessment of the acquisition or disposal of a qualifying holding in banks. The name 'common procedures' origins from the fact that, in order for the ECB to take the final supervisory decision on the subject matter, substantive involvement by the relevant NCA in the context of a unique procedure composed by both national and European decision-making processes is required. In this sense, SSM common procedures are a primary example of composite administrative procedures established by EU law instruments. Composite procedures (often referred to also as 'shared', 'integrated' or 'multilevel' procedures[386]) can be defined as those administrative procedures that consist of a pre-established order of phases, where different steps and acts lead up to the adoption of a final decision. However, what is distinctive about composite procedures is the decisional interdependence between national and EU authorities[387]. The participation in a composite procedure of different administrations acting within their own legal framework and fulfilling their

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[382] See Chapter 2, Paragraph 2.2.
[383] See Chapter 2, Paragraph 2.3.
[384] Articles 33 to 46 CRD IV sets out a framework for exercising the freedom of establishment and the freedom to provide services for EU banks ('passporting'). Building on the concept of harmonisation and mutual recognition introduced already at the end of the 1980s by Directive 89/646/EEC of 15 December 1989, the CRD IV establishes a regime of supervision that is characterised by the home country control principle and the mutual recognition of the authorisation issued by the home supervisor. Accordingly, a bank that has been granted a banking authorisation by the ECB (or by the relevant NCA, before the establishment of the SSM), or by any of the non-Eurozone NCAs, may make use of the right of establishment and the freedom to provide services within the EU. Passporting can be done through either the establishment of a branch or by the provision of services in another EU Member State. Within the SSM, any SI wishing to establish a branch within another pMS has to notify its home NCA of its intention and provide information to it in accordance with the CRD requirements. The home NCA immediately informs the ECB. The respective JST then assesses whether the requirements for establishing a branch are met. If so, it submits its assessment to the SB, which takes note thereof. DG/SGO subsequently communicates the relevant branch passport information to the SI, as well as to the home and host NCAs. After notification, the SI may establish the branch and commence its activities. If the JST concludes that the requirements are not met, it prepares a decision under the non-objection procedure. If the supervised entity wishing to establish a branch within another pMS is an LSI, it has to notify its home NCA of its intention in accordance with the CRD requirements. The NCA assesses whether the requirements for establishing a branch are met and takes a decision following the internal NCA's decision-making process. This information is made available by the home NCA to the NCA of the pMS where the branch will be established and to the ECB. If this is not the case, the NCA notifies the applicant institution of the rejection. With regard to the freedom to provide services in another pMS, the applicant SI or LSI has to notify its home NCA in accordance with the CRD requirements. The home NCA informs the ECB about the receipt of the notification and communicates the notification to the host NCA.
[385] See Article 2, point No. (3) FR.
[386] See Bastos (2018), p. 101.
[387] For a thorough analysis of derivative illegality in European composite administrative procedures, see Bastos (2018).

own responsibilities raises salient issues, not the least in relation to due process and effective judicial protection[388].

2.1.1. Authorisation to take up the business of a credit institution

The task to authorise credit institutions is assigned exclusively to the ECB under Article 4.1 (a) SSMR. This task extends to all applications for authorisation irrespective whether the credit institutions is significant or less significant, as also confirmed by Articles 6.5 (a) and Article 14 SSMR[389]. The power granted by Article 14 SSMR includes the right to grant or reject the application but neither the task nor the power to take actions if the business as a credit institution is carried out without the relevant authorisation. This task remains with the NCAs as it is not a prudential one. However, whether the NCAs take appropriate action is subject to the oversight of the ECB as otherwise the ECB has no possibility to ensure the consistent application of the prudential authorisation requirements. According to Articles 14.3 and 4.3 SSMR, the substantive law to be applied by the ECB when deciding upon an application for authorisation is the relevant Union law, that is the national law implementing the authorisation requirements provided under the CRD IV[390], as well as all additional autonomous prudential provisions set out under national law (provided that the CRD IV does not conclusively state all authorisation requirements but leaves open the possibility for Member States to set out additional ones). In particular, Article 10 CRD IV requires the applicant to provide the supervisory authority with a business plan (programme of operations) describing the types of business envisaged and the structural organisation of the credit institution[391]. In addition, Article 12 provides for an initial capital requirement (EUR 5 million) to be composed of Tier 1 and Tier 2 financial instruments. Furthermore, Article 13 CRD IV requires that at least two persons effectively direct the business of the bank[392].

With regard to the procedural steps, the authorisation procedure is a composite European administrative procedure, and it consists of two parts, i.e. a national part and an ECB part. The procedural law to be applied for the part of the authorisation procedure that has to be carried out by

[388] On the topic of composite administrative procedures in the SSM and SRM, see D'Ambrosio and Eckens (2020).

[389] As the task of granting an authorisation is conferred exclusively on the ECB, and as an authorisation is dependent on the fulfilment by the relevant legal entity of the applicable prudential requirements, national laws providing for the automatic transfer of an authorisation (e.g. in case of a merger) to a newly created legal entity would not be compliant with the SSMR (in case an existing legal entity merely changes its legal form, such concern would not exist). See Lackhoff (2017), p. 159.

[390] The relevant Articles are 8 to 16 and 19 to 21 CRD IV.

[391] As the CRD IV does further specify the content of the business plan, Member States specified the content of such requirement in various ways. In Germany, for example, in addition to the content envisaged by the CRD IV, information on the planned internal control mechanism is required. See Lackhoff (2017), p. 163.

[392] These persons shall be of sufficiently good repute and possess sufficient knowledge, skills and expertise as required by Articles 13 and 91 CRD IV. The ECB is tasked with the fit and proper assessment of these persons and shall authorise them to sit in the board of the relevant bank. It is worth mentioning that the General Court of the European Union (the '**General Court**') has ruled, in its judgment on the Joined Cases T-133/16 to T-136/16 (*Crédit Agricole v. ECB*), the term 'effective director' mentioned in Article 13 CRD IV shall be interpreted as senior management with executive functions, and that, unless exceptional circumstances exist, this definition does not apply to the Chairman of the management body in its supervisory function (para. 80), in line with Article 88.1 (e) CRD IV, and how the ECB interpreted these provisions in its *Guide on options and discretions available in Union law*. Therefore, a direct consequence of the General Court's ruling is that, unless an authorisation to combine the two functions of Chairman and director with executive functions (such as the chief executive officer) is granted by the ECB under exceptional circumstances, the management board of every SI should be composed by at least three persons (i.e. two directors with executive functions and one Chairman with supervisory functions). The case is closed as no appeal has been lodged before the CJEU.

the NCA is the national procedural law, while the ECB procedural law (established by the FR) applies in the context of the ECB supervisory procedure part. The national part is the part of the assessment carried out by the NCA that ends either with the rejection of the application on national law reasons or with the submission of a positive draft decision to the ECB. Accordingly, any application for an authorisation to take up the business of a credit institution within the SSM has to be submitted to the NCA of the Member State where the credit institution will be established. The point of entry of the authorisation procedure, therefore, is always the relevant NCA. Once the application is received, the NCA assesses it against all prudential and other non-prudential requirements set out under national law. This includes, therefore, the conditions set out in national law by implementation of the CRD IV, as well as all other prudential and non-prudential (e.g. corporate or administrative law) substantial and procedural requirements provided under national law. Within this first part of the procedure, the NCA, after its assessment, may decide, on the one hand, that all requirements to authorise the applicant legal entity to operate as a bank are met. In this case, it will provide a draft decision to the ECB, which will carry out its own final assessment according to European substantial and procedural law. On the other hand, if the NCA deems that not all national requirements are met, it can reject the application by adopting a final decision. As such administrative decision is taken by a national public authority, the judicial review of such a rejection of the authorisation is carried out before national courts. With regard to the timing, as the NCA's first part of the composite procedure may precede a ECB second supervisory procedure, and taking into account that Article 15 CRD IV provides that, in case of rejection of an authorisation application, the supervisory authority shall notify the applicant of its negative decision within six months after receipt of a complete application (and in any case, within twelve months after receipt of the application), the NCA, while applying its national procedural rules, needs to take into account and be compliant with the CRD overall time limit for the authorisation procedure. In this sense, Article 76.2 FR requires the NCA to deliver its draft authorisation decision to the ECB at least 20 working days before the end of the assessment period provided under the national law implementing the CRD IV.

After receipt of the draft authorisation decision by the NCA, the ECB will carry out its assessment. For this assessment, the SSMR provides for a period of ten working days (extendable once in duly justified cases[393]). Given such a short timeframe, realistically it can be assumed that the ECB, being the authority ultimately tasked with adopting the final decision, and in light of the principle of close cooperation with NCAs, will be informed of the substance of the application at the moment of receipt of the latter by the relevant NCA. If the ECB does not object within ten working days, the draft decision prepared by the NCA is deemed to be adopted by the ECB[394]. As mentioned, the ECB shall carry out its assessment of the application against all relevant EU law as well as the national law implementing the CRD IV. In carrying out this procedure, the ECB has to set up a hearing if it intends to reject the application[395]. Finally, the ECB will adopt a supervisory decision through the non-objection procedure[396] either to grant the authorisation, in case all preconditions are met, or to reject it. If the ECB rejects the application, it has to state the reasons for its rejection. Either decision of the ECB is notified by the ECB to the relevant NCA, and by the relevant NCA to the

[393] Article 14.3 SSMR, Article 77.1 and 77.2 FR.
[394] Article 14.3 SSMR, Article 78.3 FR.
[395] Article 77.1 FR.
[396] See Chapter 2, Paragraph IV.

applicant (and therefore not by the authority which has adopted the authorisation decision). As the notification is carried out by the NCA on behalf of the ECB, this can be considered a case of administrative assistance in which the rules of notification of Article 25 FR apply[397].

2.1.2. Withdrawal of the authorisation

According to Article 4.1 (a) SSMR, the task to withdraw the authorisation to carry out the business of a credit institution is also exclusively assigned to the ECB[398]. This task extends to all Eurozone-established bank, irrespective whether they are SIs or LSIs, and it also extends to authorisations granted prior to the establishment of the SSM[399]. The cases in which the ECB can withdraw the licence of a bank are set out under Article 18 CRD IV. In this regard, the substantial law to be applied by the ECB is again the relevant prudential EU law, i.e. the national law implementing the CRD IV and all provisions of autonomous national prudential law. In the case of a withdrawal, the ECB may also deal additionally with breaches of national requirements that are not prudential in nature and do not fall under the ECB remit, such as breaches of consumer protection, AML-CFT or payment services provisions. The possibility for the ECB to withdraw the authorization of a bank also due to breaches of non-prudential provisions is expressly contemplated by Article 18 (e) CRD IV, which provides that the ECB may withdraw the authorization in all cases where national law provides for it[400]. According to the CRD, the additional grounds for withdrawal of the authorization are that a given bank:

1) does not make use of the authorisation within 12 months, expressly renounces the authorisation or has ceased to engage in business for more than six months (unless the Member State concerned has made provision for the authorisation to lapse in such cases);
2) has obtained the authorisation through false statements or any other irregular means;
3) no longer fulfils the conditions under which authorisation was granted;
4) no longer meets the CRR Pillar 1 qualitative and quantitative capital requirements, the large exposures requirements or the liquidity requirements, or the Pillar 2 capital and liquidity additional buffers, or can no longer be relied on to fulfil its obligations towards its creditors, and, in particular, no longer provides security for the assets entrusted to it by its depositors;
5) commits one of the breaches referred to in Article 67.1 CRD IV.

The reference to Article 67.1 CRD IV extends the list of cases in which a withdrawal may be possible compared to what is provided under Article 18. Such extension includes, among others, cases of breaches of governance and securitization requirements, the maximum distributable amount threshold or reporting requirements.

With regard to the procedural steps, the withdrawal procedure, in contrast to the authorization procedure, does not consist of a two-step procedure, but it is in its entirety an ECB supervisory

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[397] In this sense, see Lackhoff (2017), p. 166.

[398] The corresponding power is laid down in Article 14.5 and 14.6 SSMR.

[399] To this purpose, according to Article 33.5 SSMR, the authorisations granted by the NCAs are deemed to be granted by the ECB.

[400] As a consequence, the legal grounds to withdraw the authorisation may vary among SSM jurisdictions and a certain legal basis available in one pMS may not be available in other countries. In these cases, the support function of the relevant NCA will be of crucial importance, as it will be the only authority in the position to provide the ECB with substantial information concerning breaches of provisions that do not fall within the scope of the ECB ongoing supervision.

procedure[401]. The withdrawal procedure can be initiated by the ECB on its own initiative or by a proposal of an NCA. If the ECB initiates the withdrawal procedure, the Authorization Division, together with the relevant JST, in the case of a SI, or DG/SPL, in the case of a LSI, assesses whether the withdrawal is justified. The threshold for withdrawal, in terms of proportionality, is rather high as the withdrawal should be seen as a supervisory measure of *extrema ratio*[402]. If the ECB has the intention to withdraw the authorization of a bank, it shall consult with the NCA of the jurisdiction in which the bank is established[403] at least 25 working days before the date on which the SB plans to adopt its final draft decision (before the non-objection procedure)[404]. In addition, in case the withdrawal concerns a SI, the ECB shall coordinate with the SRB as competent resolution authority, which may notify the ECB its objections to the withdrawal if such supervisory measure would prejudice the adequate implementation of or actions necessary for resolution or to maintain financial stability. In those cases, the ECB shall once abstain from proceeding to the withdrawal for a period mutually agree with the SRB. In taking its decision to withdraw the licence of a credit institution, the ECB shall take into account all of the following: a) its assessment of the circumstances justifying withdrawal; b) where applicable, the NCA's draft withdrawal decision; c) consultation with the NCA and the relevant resolution authority (i.e. the SRB for SIs, or the competent national resolution authority for LSIs); d) any comments provided by the credit institution[405]. The SB draft withdrawal decision is provided to the relevant bank for a hearing, which is shortened to three working days[406]. Following the hearing, the SB draft withdrawal decision is submitted to the GovC under the non-objection procedure. The final withdrawal supervisory decision, which specifies, among other things, the date starting from which the given joint-stock company cannot operate further as a bank, is notified by the ECB to the relevant bank and to the relevant NCA[407].

If the withdrawal procedure is initiated by the NCA, the latter submits a draft withdrawal decision to the ECB. This bottom-up type of procedure will likely be used for the withdrawal of authorizations of LSIs, as the NCAs are more closely involved in their supervision than the ECB, particularly in respect of compliance by LSIs with non-prudential provisions (e.g. AML/CFT requirements)[408]. In such a case, the ECB has to assess the circumstances justifying the withdrawal, also taking into account the draft proposal of the NCA[409]. This raises the question whether the ECB is bound by the assessment of the NCA on non-prudential provisions outside the scope of supervision of the ECB, or

[401] Article 2 No (24) FR.
[402] In these terms, see also Lackhoff (2017), p. 168.
[403] The consultation of the NCA aims at providing the latter with the opportunity to provide its view on the ECB intention to withdraw the authorization, but does not provide the NCA with a right to get time to adopt corrective supervisory measures. In this sense, see Lackhoff (2017), p. 169.
[404] According to Article 82.2 FR, in duly justified cases the time limit for the consultation may be reduced to five working days.
[405] Article 83.2 FR.
[406] Article 31.3 FR.
[407] Article 88 FR.
[408] It is not clear from the wording of the SSMR and the FR whether the ECB could initiate a withdrawal procedure based on non-compliance by the relevant bank with non-prudential requirements that are outside the ECB supervisory scope. For a positive answer, based on the argument that the ECB, being the only competent authority to authorise all Eurozone banks, should also be able to initiate the withdrawal procedure in all cases it would deem it necessary, see Lackhoff (2017), p. 170. Whether the ECB will concretely be able to initiate the withdrawal procedure due to non-compliance with non-prudential requirements, particularly in the case of LSIs, that will largely depend on the degree of close cooperation and information sharing with the NCAs and other national authorities.
[409] Article 14.5 SSMR and Article 83.2 FR.

whether the ECB should carry out its own assessment on non-compliance also with such non-prudential requirements. The answer should be that, in principle, the ECB should not perform a more detailed analysis on compliance with non-prudential requirements compared to the supervisory assessment carried out in the first place by the competent authority, i.e. the NCA (or any other relevant national authority). Rather, in these cases the ECB assessment should be limited to a 'consistency check' on the information included by the NCA in the draft withdrawal decision, such as if other supervisory measures (e.g. monetary penalties) to incentivise the bank to return to compliance have been taken, or if there is a clear and detailed assessment from the NCA on what non-prudential requirements have been breached specifically, and under what circumstances (e.g. what specific onsite and/or offsite monitoring information supports the NCA assessment). This conclusion is supported by the fact that the ECB, not being the competent authority, does not possess and is not in the position to demand national authorities (unless specific information-sharing arrangements are in place) all information relating to non-prudential tasks that it may deem relevant and necessary for its own possible withdrawal assessment. If one would argue that the ECB, based on information that are not directly gathered by the latter, is tasked anyway with a second review or assessment of non-compliance on top of the one of the NCA, one would not, first, respect the allocation of competences between the national and the supranational level and the fact that assessments on non-compliance lie by law with the national authorities (e.g. in the case of AML/CFT or consumer protection requirements), and would, second, jeopardise the effectiveness of the administrative procedure, as in such cases the final decision on the withdrawal of the authorization is centralised, but ongoing supervision is not (either since the withdrawal relates to a LSI and/or since the relevant provisions are not within the ECB-SSM supervisory scope). Accordingly, only if the circumstances of the case (allegedly) changed in the context of the withdrawal procedure (e.g. during the hearing, the relevant bank claims that it has returned to compliance with the regulatory framework), and no uncontested decision on this matter exists, the ECB can carry out, in close cooperation with the NCA, a critical review of the new facts of the case with a view to decide whether a withdrawal is still justified[410].

The ECB shall assess the NCA draft withdrawal decision without undue delay after receipt[411]. The SB will adopt the NCA draft decision in case no changes from the ECB side have been included, or will adopt an amended draft decision based on the one received from the NCA. The ECB draft withdrawal decision is provided to the bank for a hearing. From this point onwards, the procedure is the same as in case of a withdrawal initiated by the ECB.

2.1.3. Acquisition of qualifying holdings in credit institutions

Article 4.1 (c) SSMR confers to the ECB the task to assess notifications on the acquisition and disposal of qualifying holdings[412] in credit institutions (except in the case of a bank resolution)[413]. The corresponding power is exclusively conferred on the ECB by Article 15 SSMR. The substantial criteria against which the potential acquirer shall be assessed are determined by Article 23 CRD IV

[410] See Lackhoff (2017), p. 170.
[411] Article 81.1 FR.
[412] Article 3.1 No (33) CRD IV, Article 4.1 No (36) CRR.
[413] Recital 22 SSMR.

as complemented by the ESAs' Guidelines[414]. The procedure acts as a 'gatekeeper' to prevent credit institutions from being acquired by unsuitable buyers[415]. The procedure in case of a qualifying holding assessment is structured in parallel to withdrawals. It does not consist of a two-step procedure as the authorisation procedure, but is in its entirety a ECB supervisory procedure. Proposed acquisitions of qualifying holdings or proposed further increases of qualifying holdings in credit institutions that would result in the relevant thresholds being reached or exceeded need to be notified to the NCA of the pMS where the credit institution in which the qualifying holding will be acquired or increased is established (i.e. the NCAs are the point of entry). The NCA shall notify the ECB of such notification no later than five working days after receipt[416]. The NCA performs the initial assessment and prepares a draft proposal for the ECB. In deviation from the withdrawal procedure, in case of a qualifying holding procedure the proposal by the NCA to the ECB either to object or to approve the acquisition of the qualifying holding is required[417]. However, in contrast to the authorisation procedure, the NCA may not adopt a decision objecting to the acquisition. As Articles 4.1 (c) and 15 SSMR cover only the acquisition or disposal of a qualifying holding, the ECB is competent for the ongoing supervision of a qualifying holder only in relation to SIs[418].

In cooperation with the NCA, the ECB performs its own assessment and decides on the proposed acquisition[419]. In particular, the assessment is intended to ensure that the proposed acquirer is of good reputation and has the necessary financial soundness, that any member of the management board who will direct the business of the target institution is at all times of sufficiently good repute and possesses sufficient knowledge, skills and experience to perform his/her duties, that the targeted institution will continue to meet its prudential requirements and that the transaction is not financed with money derived from criminal activities. The formal assessment period corresponds to 60 working days from the acknowledgement of a receipt by the relevant NCA of a complete notification[420]. If additional information is requested from the proposed acquirer during the formal assessment period, the assessment period may be suspended for a period that cannot exceed 20 working days (for regulated acquirers) or, in certain cases, 30 working days (for unregulated acquirers and acquirers based in third countries). If a proposed acquirer intends to acquire stakes in a credit institution that has subsidiary credit institutions in, or owns a qualifying holding in credit institutions established in, other pMSs, the NCAs of all direct and indirect target institutions coordinate their assessments with the ECB so that all proposed acquisitions can be decided upon at the same time. This may illustrate that a detailed national implementation in areas where the CRD IV (or the ESAs' Guidelines) provide for rather broad concepts may result after the centralisation of supervision in substantial operational burdens for the single supranational supervisor. The ECB has to apply potentially diverging in substance national provisions in the context of a single composite administrative procedure. Under this

[414] EBA, ESMA and EIOPA, *Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector*, JC/GL/2016/01, 20 December 2016.
[415] See ECB (Mar 2018).
[416] Article 85.1 FR.
[417] Article 15.2 SSMR and Article 86 FR.
[418] See Lackhoff (2017), p. 172.
[419] This process is carried out together with the relevant JST in respect of SIs by the Authorisation Division of DG/SGO or, in case of a LSI, by DG/SPL.
[420] The NCA shall submit its proposal to the ECB at least 15 working days before the expiry of the assessment period. See Article 86.2 FR.

perspective, the ECB should try to interpret them in an approximating manner with a view to ensuring equal treatment of all stakeholder involved[421].

The criteria for the assessment are harmonised at the European level[422]. The CRD sets out the five criteria against which proposed acquisitions are assessed, which have been transposed into national regulatory regimes:

1) Reputation of the proposed acquirer;
2) Reputation, knowledge, skills and experience of the proposed new members of the management body of the target institution;
3) Financial soundness of the proposed acquirer;
4) Impact on the target institution;
5) Risk of links to money laundering or terrorist financing (**AML/CFT**).

The *reputation of the proposed acquirer* is assessed against the necessary integrity and trustworthiness, proven, for instance, by the absence of criminal records or legal proceedings that would have a negative impact on the proposed acquirer's reputation (in case the proposed acquirer is a legal person, criminal records would need to be provided by the members of the management body as well as by all natural persons – may be the shareholders or not – who represent 10% or more of the capital or of the voting rights, or who exercise a significant influence over the proposed acquirer). Another aspect is the acquirer's professional competence, i.e. its track record in managing and/or investing in the financial industry. Particularly in the context of complex corporate structures (such as in the case of private equity funds, hedge funds or non-banking group acquirers), the ECB may decide, within the limits of primary and secondary EU law, as well as the national laws it has to apply, to require all natural and legal persons in the holding chain, who hold directly or indirectly and by acting individually or in concert 10% or more of the capital or of the voting rights or are deemed to have a significant influence, to disclose specific information. Such information may be their names, their exact holdings of shares or voting rights, their criminal records and, in the case of legal persons, their beneficial owners.

With regard to the *members of the management body*[423], if the proposed acquirer intends to implement changes to the target institution's managing bodies, a fit and proper assessment of the new board members proposed must be carried out against the criteria set out under Article 91 CRD IV as part of the qualifying holding procedure. Members of the management body need to fulfil the fit & proper requirements and must be able to dedicate sufficient time to the position[424].

The *financial soundness* requirement is often a delicate issue and must be assessed on a case-by-case basis. Financial soundness refers to the capability of the proposed acquirer to finance the

[421] The obligation to an approximating interpretation of different national laws in so far as they provide room for interpretation is a very challenging concept resulting from the fact that a centralised supervisor has to apply harmonised but nationally (i.e. decentralised) created laws. In this context, the objectives and the provisions of the CRD IV (and EU soft-law legal acts) will likely serve as the primary basis to guide the approximating interpretation of national provisions. This results in a quasi-functioning of Directives as Regulations in case of a centralised application by a single supranational administration. See Lackhoff (2017), p. 163.
[422] Article 23 CRD IV.
[423] Article 3.1 No (8) and Article 3.2 CRD IV.
[424] Article 91.1 and Article 91.2 CRD IV.

proposed acquisition and to maintain a sound financial structure for the foreseeable future[425]. This may, *inter alia*, include i) identifying who will be responsible for supporting the target institution after the acquisition, for example by contributing to possible capital add-ons for the target institution, and ii) limiting the level of leverage of the proposed acquirer, for example through the creation of cash 'boxes' that would act as buffers to mitigate possible dividend pressure on the target.

With regard to the *impact on the target institution*, such requirement entails that after the acquisition, the target institution should still be able to comply with prudential requirements. For example, its profitability should not be put under undue stress by financing part of the acquisition through excessive debt that needs to be repaid by the target institution itself. Also, the structure of the acquirer or of the group that the target institution will become a part of should not be so complex as to prevent the supervisor from effectively supervising the institutions involved (this may be the risk particularly in the case of complex control structures with several corporate layers located in different jurisdictions). Providing for clear governance structures, independent members of the management board and procedures to avoid conflict of interests are measures to overcome such concerns[426].

Last, the funds used for the acquisition must not be the *proceeds of criminal activity or linked to terrorism*. The assessment also looks at whether the acquisition could potentially increase the risks of money laundering or terrorist financing[427]. Only when such breaches have been established by the relevant national authority (such as the AML/CFT supervisor or the Financial Intelligence Unit) can the ECB take these facts into consideration for the purposes of its own tasks.

To ensure that the five criteria above are fulfilled, the ECB may impose conditions or obligations on the proposed acquirer either based on a proposal from the NCA or of its own accord. However, any conditions or obligations imposed on proposed acquirers must relate to these five criteria and may not go beyond what is necessary to comply with the criteria[428]. If the conditions or obligations are not agreed upon by the proposed acquirer or if they could adversely affect the proposed acquirer's rights, a hearing will be conducted to give the proposed acquirer the chance to comment. The same applies if the ECB intends to oppose the proposed acquisition[429].

2.2. Investigatory powers

In order to ensure a detailed and thorough analysis of the supervised entities' business, and to carry out risk-based supervision in an effective way, the ECB performs its supervisory mandate through a combination of both off and on-site supervision. To this end, Articles 10 to Articles 13 SSMR provide

[425] If the proposed acquirer is a credit institution or another regulated entity established in the SSM, or in another EU or EEA Member State, the target institution's supervisor may rely on information to be provided by the competent supervisor of the proposed acquirer, such as the proposed acquirer i) overall risk profile, and ii) the impact of the acquisition on the proposed acquirer in terms of capital adequacy, profitability, and liquidity, with a comparison of the situation of the proposed acquirer before and after the acquisition. In the case of a non-regulated entity, relevant information that may be asked by the target's institution supervisor is a complete set of accounts, such as official annual accounts (individual and consolidated level), including the external audit report if applicable, for the last three years (in case the proposed acquirer is required under national law to keep and maintain up-to-date such information). In the case of natural person, the target's institution supervisor may request an up-to-date overview of business activities or other sources of income).

[426] See Lackhoff (2017), p. 174.

[427] As discussed, it is the task of national AML/CFT authorities to identify these risks, as AML/CFT falls outside of the mandate of the SSM and the ECB investigative powers to uncover such deficiencies.

[428] See Chapter 2, Paragraph 4.1.1.

[429] See Chapter 2, Paragraph 4.1.

the ECB with a thorough framework of on-site and off-site monitoring and investigatory tools[430] in relation to both SIs and LSIs[431]. Starting from Article 10 SSMR, this Article provides the ECB with the power to request from each information provider any information necessary to carry out is supervisory tasks. Indeed, in order to carry out risk-based supervision effectively, the possibility for the ECB to receive information on *ad hoc* basis, in addition to ongoing reporting, is of crucial importance. Article 10 SSMR stipulates that *ad hoc* information requests must be proportional, that is an information request is justified if i) the information is reasonably needed by the ECB in connection with any of its tasks, and ii) requesting the specific information entails a reasonable (i.e. proportional) strain on the side of the bank to collect and provide information to the supervisor[432]. Accordingly, the ECB decision requiring information needs to state which supervisory task the ECB pursues and why the information is necessary for pursuing it[433]. The request for information may be posed to the information provider directly by the JST in the form of an operational act, or in a formal ECB supervisory decision[434].

In addition, Article 10.1 SSMR entrusts the ECB (normally acting through the relevant JST) with the power to request reporting information at recurring intervals and in specified formats for supervisory and related statistical purposes. The scope of such reporting requests is the same as the one of *ad hoc* information requests. If EU law already sets out reporting obligations for supervised entities in a specific area, such as, for instance, in relation to own funds in the context of the common reporting framework for solvency ratios (**COREP**)[435], the ECB may only complement existing EU-wide obligations but not add new ones[436]. Importantly, Article 140.3 FR provides that NCAs are the point of entry for the reporting of SIs. An ECB decision[437] addressed to NCAs specifies the format, frequency and timing of the provision of reported information by the NCAs to the ECB and the quality

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[430] It is worth noting that the ECB investigatory powers extend to a broader group of persons (the '**information providers**') than the group of supervised entities subject to ECB supervision. In particular, Article 10.1 SSMR provides that potential addressees of a request for information, a general investigation or an on-site inspection are not only the supervised entities, but also i) mixed activity holding companies (established within the Eurozone) as defined by Article 4.1 No. 22 CRR, ii) persons belonging to one of the aforementioned entities (affiliated persons), and iii) third parties to whom these entities have outsourced functions or activities (outsourcing providers). Affiliated persons and outsourcing providers, however, cannot be the addresses of on-site inspections, as the latter may be carried out only at a legal person. Affiliated persons can be defined as the subsidiaries and any other affiliated company of the relevant SI, as well as individuals like the board members or the employees of the bank. Outsourcing providers are the persons and undertakings that a supervised entity (or a mixed activity holding company) has engaged for the provision of a part of the regulated services covered by the authorisation to operate as a bank. While only supervised entities and mixed activity holding companies that are established in a pMS are subject to the investigatory powers of the ECB, affiliated persons and outsourcing providers may even be located outside the perimeter of the SSM. See Lackhoff (2017), p. 178.

[431] Article 6.5 (d) SSMR and Article 138 FR.

[432] For instance, a ECB request for information may not be considered proportional if the required information is readily available at an NCA (or at the ECB itself). See Article 139.2 FR.

[433] Art. 10.2 SSMR makes clear that '*professional secrecy provisions do not exempt those persons from the duty to supply that information. Supplying that information shall not be deemed to be in breach of professional secrecy*', including banking secrecy rules.

[434] See Lackhoff (2017), p. 179.

[435] Article 99 CRR and Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council.

[436] In this sense, see Regulation (EU) 2015/534 of the European Central Bank of 17 March 2015 on reporting of supervisory financial information (ECB/2015/13).

[437] Decision of the European Central Bank of 2 July 2014 on the provision to the European Central Bank of supervisory data reported to the national competent authorities by the supervised entities pursuant to Commission Implementing Regulations (EU) No 680/2014 and (EU) 2016/2070 (ECB/2014/29) (2014/477/EU).

checks that NCAs shall carry out. Article 10 SSMR is complemented by Article 11 SSMR, which lays down a framework on general investigations. In particular, Article 11.1 SSMR stipulates that the ECB (normally acting through the relevant JST) may conduct all necessary investigations at natural and legal persons[438]. Investigations include i) the demand to submit documents, ii) the examination of books and records, iii) the obtaining of written or oral explanations from any information provider, iv) the right to interview any persons who consents to be interviewed for the purpose of collecting information relating to the subject matter of an investigation. As much as in the case of *ad hoc* information requests or reporting, a general investigation request may be posed directly by the JST in the form of an operational act, or in a formal ECB supervisory decision[439].

Article 12 and 13 SSMR provide the ECB with the right to carry out all necessary on-site inspections at the business premises of the supervised entities[440]. As discussed, while ongoing supervision is mainly conducted by the JSTs in Frankfurt am Main (and the relevant NCA), on-site supervision grants the power to the ECB to enter and inspect the business premises of supervised entities. The ECB power extends to i) the information providers (only if legal persons) and ii) any other undertaking included under the remit of ECB consolidated supervision (such as an asset management company controlled by a supervised entity). As this power represents the most intrusive investigatory measure of the ECB, it is subject to prior notification to the NCA of the jurisdiction where the bank's premises are located, and communication to the supervised entity, through a formal ECB supervisory decision, of the ECB intention to carry out an inspection, together with the date when it will take place. Under exceptional circumstances, '*where the proper conduct and efficiency of the inspection so require, the ECB may carry out the on-site inspection without prior announcement*'[441].

In order to carry out on-site inspections, the ECB appoints inspection teams composed by both ECB and NCAs officials[442]. In case of obstruction, the relevant NCA provides for appropriate assistance, including the sealing of any business premises and books or records. Where that power is not available to the NCA concerned, it uses its powers to request the necessary assistance of other national authorities[443]. Such provision implies that, in the context of an on-site inspection authorised by the ECB, the NCA must assist, if necessary, also by (police) force and by sealing any business premises and books or records[444]. Due to their coercive nature, on-site inspections and forced sealing may require judicial authorisation in several Member States. When that is the case, the prior authorisation should be obtained before the investigatory measure takes place. This dependence on national law leaves room for differences between the Member States composing a variable geometry puzzle[445]. As in the case of withdrawal of the banking authorisation due to breach of national requirements, national legal specificities represent a significant challenge for the ECB as regards the

[438] See also Article 142 FR.
[439] See Lackhoff (2017), p. 181.
[440] On the ECB power to conduct on-site inspections, see Zagouras (2018); Lackhoff (2017), pp. 181-186; Allegrazza and Voordeckers (2015).
[441] Article 12.1 SSMR.
[442] The planned on-site inspection process consists of five phases: i) planning, ii) preparation, iii) execution, iv) reporting and v) follow-up. For a detailed discussion, see Zagouras (2018); Lackhoff (2017).
[443] Article 12.5 SSMR.
[444] See Zagouras (2018), p. 5.
[445] See Allegrazza and Voordeckers (2015), p. 154.

homogeneous application of the SSM in the Eurozone. Furthermore, Art. 13 of the SSMR limits the effectiveness of judicial review by the national courts, by stipulating that national courts '*shall control that the decision of the ECB is authentic and that the coercive measures envisaged are neither arbitrary nor excessive having regard to the subject matter of the inspection*'[446]. In substance, national courts are entitled to review i) the authenticity of the ECB decision to carry out the on-site inspection (but not its lawfulness, as this power pertains to the CJEU), and ii) its proportionality in narrow sense, i.e. that the coercive measures envisaged are neither arbitrary nor excessive. Accordingly, national courts shall not review the necessity for the inspection and they cannot have direct access to the ECB's file. While the 'how' of the coercive measures may be reviewed by the national courts, the question 'whether' such inspection is lawful, suitable and necessary to carry out the ECB supervisory mandate may only be reviewed by the CJEU[447].

2.3. The macroprudential framework

As discussed, the establishment of the SSM in 2013 centralised to the ECB the ongoing supervision, and related microprudential tasks and powers, of SIs. Additionally, and to follow-up on the new regulatory framework laid down by Basel III to address systemic risk and the transmission of macroeconomic shocks across financial systems and the broader economy[448], Article 5 SSMR entrusted the ECB also with specific macroprudential powers in relation to all banks of pMSs. As a consequence, the ECB, within the SSM framework, is currently responsible to address two distinct, though closely interrelated, dimensions of risks: systemic and institution-specific[449]. The ECB's powers are exercised in coordination with other EU authorities, notably the ESRB for macroprudential issues[450], and the ESAs for microprudential issues.

[446] Article 13.2 SSMR.
[447] In this sense, see Lackhoff (2017), p. 185.
[448] See Chapter 1, Paragraph II.
[449] Macro- and microprudential policies have distinct objectives and therefore distinct perspectives. The main policy objective of the macroprudential policy is to limit financial system-wide distress, while microprudential supervisors are focusing on limiting distress of individual financial institutions. As a result of this policy objective, macroprudential policy supervisors are aiming at avoiding costs related to financial instability and are primarily focusing on correlations and common exposures across financial institutions (while these correlations are not primarily in the focus of micro-prudential supervisors, as their ultimate goal is to ensure the soundness of individual financial institutions and consumer protection). See Grigaitė et al. (2020), p. 2.
[450] In 2009, the de Larosière Report plainly stressed to EU Institutions that the strengthening of EU-wide supervisory arrangements should concentrate not only on the supervision of individual firms but also on the stability of the financial system as whole, and recommended the establishment of a Union-level body with the mandate to oversee systemic risk in the financial system. To this end, the Report (p. 38) laid out that '*[t]he objective of macro-prudential supervision is to limit the distress of the financial system as a whole in order to protect the overall economy from significant losses in real output. While risks to the financial system can in principle arise from the failure of one financial institution alone if it is large enough in relation to the country concerned and/or with multiple branches/subsidiaries in other countries, the much more important global systemic risk arises from a common exposure of many financial institutions to the same risk factors. Macro- prudential analysis therefore must pay particular attention to common or correlated shocks and to shocks to those parts of the financial system that trigger contagious knock-on or feedback effects. Macro-prudential supervision cannot be meaningful unless it can somehow impact on supervision at the micro-level; whilst micro- prudential supervision cannot effectively safeguard financial stability without adequately taking account of macro-level developments*'. The ESRB was then established in 2010 as the EU body responsible for '*the macroprudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of* systemic risks to financial stability *[...]*' (Article 3.1 ESRB Regulation) and coordination of EU policies for financial stability. The ESRB is composed of the ECB, national central banks, representatives of the ESAs and EC (as voting members), as well as national supervisory authorities and the president of the Economic and Financial Committee (as non-voting members). The ESRB

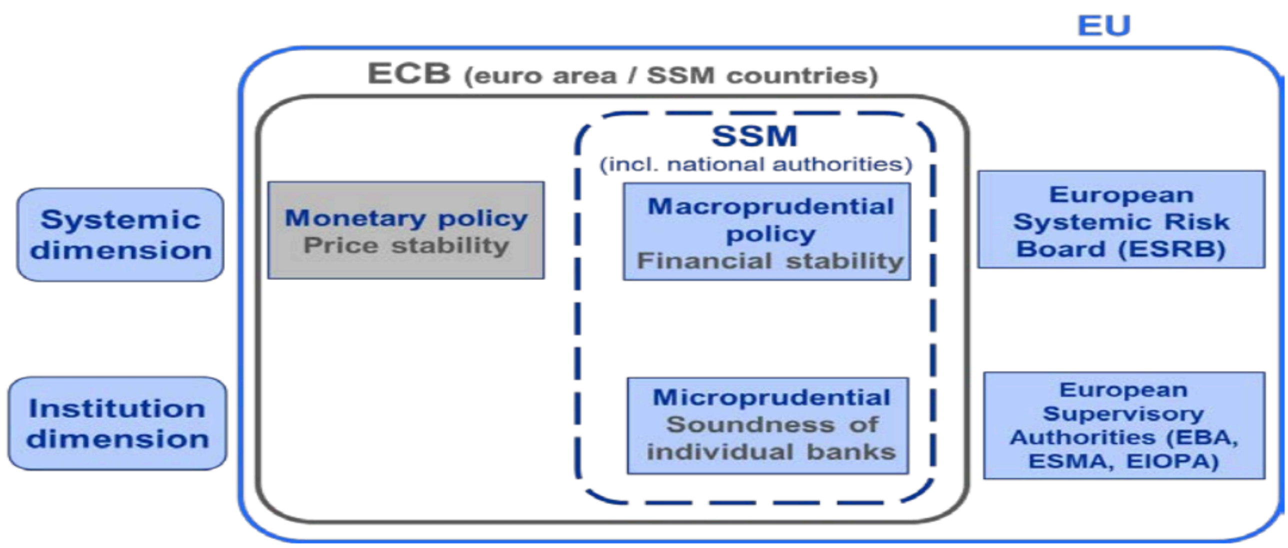

Figure 10. *Monetary and prudential policies at the ECB.*
Source: Constâncio, ed., et al. (2019), p. 19.

Macroprudential tasks and powers were conferred to the ECB in particular (and not to any other existing or new institution) in order to benefit from common access to information, to exploit synergies between policy areas and to work within a consistent analytical framework[451]. A significant overlap between the nature of the instruments used in microprudential supervision and those used in

is chaired by the ECB President. The ESRB has been tasked with a broad remit of macroprudential oversight that extends to financial intermediaries, markets and infrastructures and their practices, and therefore covers, among others, banks, insurers, asset managers, central counterparties and financial market infrastructures. Within this remit, the ESRB is responsible for analysing and monitoring all risks to financial stability, whatever their source is, either originating from inside or outside the EU financial system. To this end, the ESRB has been called to develop a common set of quantitative and qualitative indicators (risk dashboard) to identify and measure systemic risk, and issue warnings and recommendations for remedial action in response to the risks identified. The addressees of such legal instruments, which are legally non-binding, may be i) the EU as a whole, ii) one or more EU Member States, iii) one or more of the ESAs, or iv) one or more of the national supervisory authorities. Consequently, the ECB may be the addressee of legal instruments issued by the ESRB, either in its monetary or supervisory function. Though being formally separate from the ECB and the ESCB, the ESRB, as a new EU law body integrated into the EFSF, receives administrative support for its functioning and daily business from the ECB (according to Recital 9 of Council Regulation (EU) No 1096/2010 of 17 November 2010 conferring specific tasks upon the ECB concerning the functioning of the ESRB, the ECB is mandated to '*provide analytical, statistical, administrative and logistical support to the ESRB, also drawing on technical advice from national central banks and supervisors*'). Such technical assistance has been achieved through the establishment of an ESRB Secretariat and the provision of human and financial resources for the fulfilment ESRB's tasks. As such, the ESRB Secretariat, located in Frankfurt am Main at the ECB's premises, is the body responsible for the day-to-day business of the ESRB, its tasks spanning from the preparation of meetings to the collection and processing of statistical data enabling the ESRB to achieve its mandate. Coherently with such framework, the ESRB has no legal personality and hard-law powers. For a detailed analysis of the institutional setup of the macroprudential policy framework at EU level and the macro-prudential powers and tasks of the ECB-SSM, see Dias et al. (2020); Constâncio, ed., et al. (2019); Amorello (2018); Lackhoff (2017), pp. 186-190. For a comparison of the macroprudential framework between the EU and the United States, see Napoletano (2014).

[451] Within its institutional framework, the ECB also hosts several fora that foster discussions among Eurozone's central bankers and supervisory authorities. In particular, the Macroprudential Forum (**MC**), composed of the members of the GovC and the SB, operates as a platform for regular discussion at the highest level, bringing together the micro- and macroprudential perspectives across the SSM. The Macroprudential Forum acts as a preparatory phase for the macroprudential policy decisions before they go for final vote at the GovC. Additionally, the Financial Stability Committee (**FSC**) is the main technical committee of the ESCB supporting the ECB in the area of macroprudential policy. It includes high-level representatives from the national central banks and supervisory authorities of the SSM Member States. It advises the GovC on macroprudential matters and potential policy responses, including draft proposals on the activation of macroprudential tools (see Chapter 2, Paragraph 2.3.2).

macroprudential policy is the most prominent feature, that is both a point of strong synergy and a challenge. Nevertheless, the down side of this framework is that potential conflicts of interest between micro- and macroprudential policy may arise not only from the overlaps between the toolkits, but also from differences in the optimal timing of the implementation of policy measures[452]. Notably, in good times or periods of excessive credit growth, microprudential requirements may decrease (e.g. falling risk weights as probability of defaults and loss given defaults decrease), while macroprudential requirements may increase (e.g. activation of the countercyclical capital buffer). Conversely, in bad times/stress periods, microprudential authorities typically become stricter (e.g. increasing capital add-ons to protect depositors), while macroprudential authorities may aim to relax requirements (e.g. releasing the buffers to support lending). Finally, the fallacy of composition suggests that what is optimal for addressing risk at the institution level may not always be optimal for addressing risks at the systemic level[453]. Therefore, if implemented independently, micro- and macroprudential measures may offset each other. Under this perspective, the SSM framework enables to better assess potential trade-offs and unintended consequences of micro- and macroprudential measures. Since prudential requirements at the institution and systemic levels are determined jointly by the actions of micro- and macroprudential authorities, the coordination of policy actions is of key importance[454].

Since the establishment of the SSM, therefore, national authorities and the ECB are jointly responsible for addressing systemic risk within the EU and, as highlighted above, the SSMR gives the ECB the power to tighten certain measures implemented by national authorities. However, the ECB has no power to 'scale down' national measures. The asymmetric nature of the powers assigned to the ECB aims at ensuring that systemic risk is properly addressed at the SSM level in case the national authorities do not take adequate action to implement macroprudential measures. This set-up also reflects the expectation that the national authorities will be proactive in responding to the specific conditions experienced in their country at any particular time. In view of its specific role in ensuring that action is taken at the SSM level, the ECB focuses on identifying cross-border risk and contagion effects, analysing cross-border implications of policy measures and reciprocating national macroprudential policies[455].

2.3.1. Macroprudential supervisory powers transferred to the ECB

According to Article 5 SSMR, the macro-prudential powers are not conferred exclusively on the ECB like the micro-prudential tasks and powers listed under the SSMR. Rather, macroprudential supervisory powers remain with the national designated authorities (**NDAs**)[456], subject to a

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[452] See Dias et al. (2020), p. 5. To address such concerns, a clear governance structure set out in the SSMR allows the ECB to perform both of these mandates, and that of monetary policy authority, whilst reducing potential conflicts of interest.

[453] These considerations relate to the issue previously discussed of the application of the 'too-big-to-fail' doctrine and the system-wide externalities created by risk-taking behaviours of single actors, such as G-SIFIs and G-SIBs. See Chapter 1, Paragraph 3.1.

[454] See Constâncio, ed., et al. (2019), p. 25.

[455] *Ibid.*, p. 20.

[456] In 2011, the ESRB recommendation ESRB/2011/3 requested EU Member States to establish National Macroprudential Authorities (**NMAs**). Such authorities are '*entrusted with the conduct of macro-prudential policy*' on the application of macroprudential instruments (see Section 1, Recommendation B, ESRB/2011/3) and to define an operational policy strategy to monitor macroprudential oversight-related indicators and, if need be, take action to address systemic risk for their respective national financial systems. Furthermore, the ESRB requested EU Member States to entrust the NMAs

notification and coordination mechanism vis-à-vis the ECB. In particular, the ECB macroprudential powers referred to by Article 5 SSMR relate to the macroprudential instruments provided under the CRD package. In respect of these instruments, the ECB may only set stricter requirements than the NDAs, or set requirements in case the relevant NDA remains inactive (top-up power)[457]. In this sense, the SSM macroprudential framework differs significantly from the newly-established microprudential supervisory regime, as the implementation of macroprudential measures within the SSM is as a shared competence between the ECB and the relevant NDA, where both authorities can autonomously and in parallel, though in a coordinated fashion, activate the macroprudential tools provided under EU law. While this flexible use of macroprudential tools can support financial stability and, thus, the single market, the risk that this can lead to ineffective domestic ring-fencing remains[458].

The ECB macroprudential instruments for the banking sector can be classified as i) capital-based measures, ii) liquidity-based measures, iii) borrower-based measures[459], and iv) other instruments.

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with a set of minimum powers and instruments and ensure their independence, as well as that NMAs may cooperate and share information with other domestic authorities and with EU counterparts (namely the ESRB). In 2013, the CRD IV innovated this institutional set-up as it required EU Member States to institute national designated authority (**NDAs**) responsible for the application of the macroprudential measures included in the CRD IV package and for setting the rates of macroprudential capital buffers. As a consequence, following the establishment of NDAs, the allocation of macroprudential competences and powers between NDAs and NMAs became unclear. Indeed, in 16 EU Member States these two functions are centralised to the same authority (usually the Central Bank), while in the remaining 10 EU Member States the tasks and powers of the NMA and the NDA are currently vested with different public authorities or bodies. The only exception is Italy, which never formally designated a NMA, and *de facto* entrusted the macroprudential responsibilities included in the 2011 ESRB recommendation to *Banca d'Italia*. With regard to SIs, the ECB-SSM acts as either NMA and NDA. Within this framework, Dias et al. (2020), p. 4, argue that the selection, calibration and (de)activation of macroprudential measures always falls into the remit of NMAs, whereas their implementation may be either performed by the NMAs themselves or by NDAs (in the Member States where the NMA and NDA are not the same). However, such allocation of competences is not convincing for two reasons. First, the CRD IV expressly entrusts to NDAs (and not NMAs) the activation and the setting of rates in relation to macroprudential capital buffers, making no reference to the 2011 ESRB recommendation in this respect. Second, the allocation of competences proposed by the Authors would imply that, at least formally, in Italy no authority would have ever been allowed to set macroprudential capital buffers (while this task, in fact, was carried out by the Central Bank of Italy as NDA). On the other hand, Lackhoff (2017), p. 188-190, argues that, within the SSM framework, macroprudential measures can be adopted by NDAs, while the Author never mentions NMAs. However, also this position may be criticisable as it seems not to take into account the institutional and policy objectives of the 2011 ESRB recommendation. Indeed, one can safely argue that the current EU macroprudential architecture, and its relationship to the monetary policy conduct, is overly complex and inefficiently developed. EU legislative bodies should urgently re-discuss the current framework and reach consensus on how to streamline it, as the latter clearly is the result of an inefficient set of institutional reforms that were implemented by EU authorities over the last two decades as a response to, first, the 2007-08 global financial crisis and, then, the sovereign debt crisis (i.e. the establishment of the ESFS in 2011, the implementation of Basel III in 2013 and the establishment of the EBU in 2014). In this sense, Amorello (2018), p. 307, argues that '*the complexity of the [EU] macroprudential supervisory structure might endanger the policy assignments and responsibilities, as multiple authorities may be willing to counter and/or mitigate systemic risks in an uncoordinated fashion, with possible negative spillovers for a coherent deployment of the macroprudential policy strategies. This complexity may then create substantial burden for the smooth interaction of the macro- prudential measures with the monetary policy environment, as only few regulatory and institutional arrangements are settled to provide an alignment between the policies at stake*'. Being mindful that there is no optimal solution, in the context of this work the term NDAs, in line with language used in the CRD IV, indicates those national authorities responsible for deciding on the application of macroprudential supervisory measures and setting rates with regard to macroprudential capital buffers.

[457] See Lackhoff (2017), p. 186.

[458] See de Guindos (2019).

[459] While the other macroprudential measures typically affect financial institutions' balance sheets, borrower-based tools affect the terms and conditions of financial transactions by making the volume of credit granted dependent on the value of the underlying real estate or on the debt servicing capacity of the borrower, in this way working mainly on the demand rather than the supply side. In this sense, borrower-based measures, which are provided for under the Basel framework,

Capital-based measures aim primarily at increasing the resilience of the institutions so that they have sufficient loss-absorbing capacity on a going concern basis. The macroprudential capital requirements referred to by Article 5 SSMR are the capital buffers included from Articles 128 to Articles 142 CRD IV. These measures can be classified as i) 'hard requirements', which are expected to be met at all times (such as the Basel minimum own funds requirements[460] together with the capital conservation buffer) and ii) 'buffers', which banks can use in stress periods, subject to certain restrictions on distribution (such as restrictions on dividends, bonuses or coupon payments on hybrid capital instruments). Buffers can address cyclical or structural risks (such as the countercyclical capital buffer and the systemic risk buffer, respectively), as well as the 'too-big-to-fail' problem posed by large, complex, highly interconnected institutions (such as the capital buffers for systemically important institutions)[461]. The CRD IV provides for four types of buffers[462] (which are not necessarily cumulative):

i. capital conservation buffer (Article 129 CRD IV);
ii. an institution-specific countercyclical buffer (Article 130 CRD IV);
iii. risk buffers for systemically important institutions, i.e. G-SIBs (Article 131.4 CRD IV) and other systemically important banks (**O-SIBs**)[463] (Article 131.5 CRD IV); and

aim at addressing the vulnerabilities of banks' clients directly, and have proven to be an effective tool in mitigating the financial cycle in several jurisdictions. However, these measures have not been transposed by EU regulators into the CRD package and the broader EU legal framework. Therefore, borrower-based macroprudential tools can be currently applied only by those EU national authorities whose regulatory frameworks provide for such measures. They usually take the form of i) Loan-to-value (**LTV**), ii) Loan-to-income (**LTI**), and iii) Debt(service)-to-income (**DTI**) requirements. LTV sets a cap on the ratio of the value of the loan relative to the underlying collateral, typically residential property, and is usually applied to new loans. The aim is to increase resilience against excessive credit growth (by limiting loss given default) and address the credit cycle in housing. The LTV cap can be set as a static or time-varying limit, potentially addressing both the cross-sectional and the time dimensions of risk, and it is widely used around the world. LTI and DTI limits set a cap on the amount of debt or on the debt servicing costs relative to the borrower's disposable income. The objective is similar to that of LTV, but more focused on limiting the probability of default. Depending on its design (static/time-varying), LTI and DTI caps can address either the cross-sectional or the time dimension of risk. The use of any of these measures (LTV, LTI, DTI) may be part of a policy aimed at fostering responsible borrowing and have the key goal to strengthen banks' capital base and prevent excessive credit growth and leverage. On borrower-based macroprudential measures, see ESRB (2018); Amorello (2018); Napoletano (2014).

[460] Within the EU capital adequacy framework, Basel minimum capital requirements have been transposed under Article 92 CRR. See Chapter 3, Paragraph II. for a through discussions of EU capital adequacy requirements and related supervisory powers at disposal of EU authorities.

[461] See Constâncio, ed., et al. (2019), p. 22. For a discussion of these issues and the regulatory response enacted by international standard-setters, backed by G-20 leaders, through the 'G-SIB framework', see Chapter 1, Paragraph III. ff.

[462] For an overview table, see Gortsos (2015), p. 155.

[463] As discussed under Chapter 1, Paragraph 3.1., the additional capital requirement applied to G-SIBs, which applies over and above the Basel III minimum capital ratio, is intended to limit the cross-border negative externalities on the global financial system and economy associated with the most globally systemic banking institutions. However, similar externalities can apply also at the domestic level. As acknowledged by the BCBS, there are many banks that are not significant from an international perspective, but nevertheless could have an important impact on their domestic financial system and economy compared to non-systemic institutions. Some of these banks may have cross-border externalities, even if the effects are not global in nature. Therefore, similarly to the case of G-SIBs, the BCBS considered appropriate to review ways to address the externalities posed by domestic systemically important banks (**D-SIBs**). This was in line with the request from G20 leaders to strengthen the resilience of financial systems (see G-20 Leaders' Declaration, Cannes Summit Final Declaration, 4 November 2011, Section 29). Accordingly, in October 2012, the BCBS, following consultation with the FSB, published a methodology composed of 12 principles to guide national authorities in the identification of D-SIBs. The BCBS D-SIB framework is best understood as taking the complementary perspective to the G-SIB regime by focusing on the impact that the distress or failure of banks (including by international banks) would have on the domestic economy. As such, it is based on the assessment conducted by national authorities, who are best placed to evaluate the impact of failure on the local financial system and the local economy. Therefore, in contrast to the prescriptive approach of the G-SIB framework, the D-SIB framework allows for a significant margin of national

iv. systematic risk buffers (Article 133 CRD IV).

The combined buffer requirement[464] is the total CET1 to RWAs capital ratio required to be met by banks and composed of i) the 2.5% capital conservation buffer, and ii) the requirement for other macroprudential buffers as applicable. While the capital conservation buffer requires to be met by banks with a pre-defined amount of capital of the highest quality, the ECB is tasked with setting the rates of the other institution-specific macroprudential buffers (as regards the G-SIBs capital surcharge, this is done according to the provisions of the EBA methodology[465] and in close

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discretion and entrusts national authorities with the identification of D-SIBs. At the same time, as the D-SIB framework is relevant for reducing cross-border externalities due to spillovers at regional or bilateral level, the BCBS established a minimum set of principles, which promotes a global level playing field and ensures the effectiveness of national authorities' assessments in addressing risks posed by domestic banks which are of interest to a wider group of countries. As much as in the case of G-SIBs, the BCBS 12 principles set out in D-SIB methodology focus on higher loss absorbency requirements to be fully met by CET1 instruments. In particular, principles 1 to 7 mimic the methodologies and the best practices outlined by the BCBS in respect of G-SIBs. However, they incorporate a proportionality feature due to their adaptation to domestic banking systems. Accordingly, a relevant difference is that the D-SIB framework does not mention global (cross-jurisdictional) activity as a criterion to identify banks as D-SIBs. Principles 8 to 12 set out considerations on the national approach to quantify additional capital surcharges for D-SIBs. In this sense, the BCBS D-SIB framework mandated domestic authorities to develop, in accordance with international principles, national methodologies to calibrate capital surcharges for D-SIBs in their jurisdiction. As additional capital requirements should be commensurate with the degree of systemic importance, the BCBS in its methodology (Principle 5) set out bank-specific factors to be taken into consideration by domestic authorities in the context of their assessment, namely: i) size, ii) interconnectedness, iii) substitutability/financial institution infrastructure (including considerations related to the concentrated nature of the banking sector), and iv) complexity (including the additional complexities from cross-border activity). Home authorities should impose higher loss-absorbency requirements that they calibrate at the parent and/or consolidated level, while host authorities should impose additional capital requirements that they calibrate at the sub-consolidated/subsidiary level. In case a banking group were to be identified as both a D-SIB and G-SIB in the home jurisdiction, national authorities should impose the higher of either the D-SIB or G-SIB higher capital surcharge. Within the EU, the EBA, as mandated by Article 131.3 CRD IV, published in December 2014 the Guidelines on the criteria for the assessment of other systemically important institutions (**O-SIIs**) to be applied by NCAs in their national assessments. The methodology laid out by the EBA is largely aligned with the BCBS global framework. The EBA Guidelines require NCAs to assess systemic risk and provide for a two-steps approach. First, NCAs initially assess banks through a predefined set of criteria and indicators, which reflect negative events and look at weaknesses from a financial stability perspective. In this stage, banks are given a score from 0 to 10000 bps representing their systemic riskiness. In the following stage, NCAs further assess through other quantitative or qualitative factors banks which might have not been already identified as O-SIIs, but may be specific and significant in their own financial system. Pursuant to Article 131.5 CRD IV, the higher loss absorbency requirements to be set by NCAs as a result from this identification process may correspond to up to 2% of CET1 to RWAs. The O-SIIs identification process takes place on a yearly basis. As at 2019, in the EU there are 188 identified O-SIIs (in addition to 8 G-SIBs). For the BCBS global framework to the identification of D-SIBs, see BCBS (Oct 2012). For the EU implementation, see EBA (Dec 2014).

464 Article 128.6 CRD IV.

465 As discussed in Chapter 1, Paragraph 3.1., in July 2018 the BCBS published an update to its approach to identifying G-SIBs. This second version replaced the July 2013 BCBS methodology that had for the first time established an international framework for identifying G-SIBs. In response to that, the CRD V mandated the EBA to update the indicators of the RTS on the EU methodology for identifying G-SIFIs. On 4 November 2020, the EBA published the revised version of its Guidelines that will be submitted to the EC for endorsement. In particular, the EBA updated the methodology for the identification of G-SIBs to exclude the cross-border activities of EU banks in pMSs, with the aim of recognising the efforts made in recent years to create harmonised European banking regulation and a common approach to resolution. Within the same document, the EBA also updated its soft law guidance on G-SIBs disclosure, which apply, in addition to banks that have already been identified as G-SIBs, to other large EU financial institutions that have an overall leverage ratio exposure measure exceeding EUR 200 billion. The key objective of the EBA's disclosure revisions is to enable EU national authorities to perform the identification and scoring process and disclosure in a timely manner, and in particular before the identification of any financial institution as G-SIFI (or G-SIB). It is worth mentioning that the EBA methodology for identifying G-SIFIs closely follows the approach of the BCBS to identifying G-SIBs. Indeed, the list of EU G-SIBs identified by the BCBS/FSB and the banks identified as G-SIBs by EU and national authorities have been identical since 2014, and are expected to remain so in future. Following publication in the OJ, NCAs (including the ECB) will need to report to the EBA whether they intend to comply with the revised version of the Guidelines. See EBA (2020).

cooperation with the BCBS and the FSB[466]). In particular, the ECB, in its supervisory function of NDA/NMA, can exercise supervisory judgment and possibly re-allocate a G-SIB or an O-SIB from a lower bucket to a higher one, or vice-versa, in line with the methodological principles compiled by the BCBS and EBA.

Liquidity-based macroprudential measures refer to adjustments, for macroprudential purposes, to the liquidity ratios as introduced by the Basel III and the CRR, namely the LCR and the NSFR[467]. While both standards have been designed as microprudential tools, they can also be used to target either the cyclical or the structural dimension of systemic risk. In particular, the LCR can be adjusted to counter the financial cycle, or a higher LCR can be (temporarily) applied to G-SIBs or O-SIBs than to the entire banking system to address specific interconnectedness and concentration macroprudential risks[468].

In addition, further macroprudential supervisory instruments are[469] i) the temporary measures for domestically authorised banks, or a sub-set of these banks, intended to mitigate the changes in the intensity of systemic risk as adopted under the EU procedure laid down by the CRR 'flexibility clause'[470], ii) the setting of higher risk weights than those set out under Article 125.2 and 126.2 CRR in relation to exposures fully secured by mortgages on residential or commercial immovable property, respectively, and iii) the setting of minimum LGD values for exposures secured by residential or commercial immovable property[471]. These last macroprudential measures that target banks' balance sheets, while not directly setting higher capital requirements as the aforementioned buffers, achieve indirectly a comparable outcome in the form of an increase of banks' own funds through one of the components used in the calculation of the capital ratio, such as RWAs s or LDGs vis-à-vis certain

[466] See Chapter 1, Paragraph 3.1.
[467] For an overview of the Basel III liquidity requirements, see Chapter 1, Paragraph 2.3.
[468] Other liquidity tools, such as liquidity risk charges on non-stable funding or requirements on the Loan-to-deposit (**LTD**) ratio, are currently outside the EU legal framework and can therefore be applied only by national authorities that have included them in their national frameworks. In particular, liquidity risk charges, as a Pigouvian levy (or tax), may be imposed on short-term funding in proportion to the negative externalities created by a bank that increase the financial system's systemic risk. In this sense, charges should be stable, but adjustable by the macroprudential authority in response to aggregate risk accumulation, such as asset bubbles based on fragile funding, and broader systemic stability goals. Accordingly, a liquidity surcharge specific to SIFIs could also be designed. See ESRB (2018), p. 138. Pigouvan levies (or taxes) are applied to a market activity in order to address the negative externalities generated by it (i.e. costs incurred by parties not engaging in the activity). See Pigou (1920). On the other hand, macroprudential unweighted limits on less stable funding, such as the LTD ratio, may serve as a macroprudential liquidity instrument and complement the LCR and NFSR framework. In particular, the LTD ratio, which is a reliable indicator on banks' structural liquidity position, can mitigate systemic risks by correcting excessive dependence on less stable market funding (assuming that customer deposits are a relatively stable source of funding for banks). It can also be used – structurally or cyclically – in a preventive fashion, to control credit and leverage vis-à-vis the real economy. On macroprudential liquidity measures, see Napoletano (2014), p. 168.
[469] See also Lackhoff (2017), p. 187; Gortsos (2015), p. 156; Napoletano (2014), p. 164.
[470] As these measures target macroprudential or systemic risk at the level of a Member State specifically, they can be activated only by the NDAs (and not the ECB). In particular, such measures may be adopted following changes in the intensity of macroprudential or systemic risk, together with an explanation by the relevant NDA of the reasons why such changes could pose a threat to financial stability and the real economy, and an assessment of the likely positive or negative impact of the draft measures on the internal market. Such measures (which are not necessarily cumulative) may concern i) the level of own funds, ii) large exposures requirements, iii) Pillar 3 disclosure, iv) the level of the capital conservation buffer, v) liquidity requirements, vi) risk weights for targeting asset bubbles in the residential property and commercial immovable property sector, and vii) intra-financial system exposures. The draft measures need to be notified to the EP, the Council, EC, ESRB and EBA. The Council, acting by qualified majority and following a proposal from the EC, may decide to reject the draft national measures proposed by the relevant NDA.
[471] Article 164.5 CRR.

types of exposures, when microprudential requirements are judged as not adequately covering the systemic risk inherent in specific activities[472]. They may address both the cross-sectional and the temporal dimensions of risk. Frequently, EU Member States use them to deal with real-estate markets[473].

2.3.2. Procedural aspects

With regard to the application of the macroprudential instruments, the specific procedural rules set out in Article 5 SSMR shall ensure mutual information of the ECB and the NDAs prior to the application of macroprudential instruments and taking into account the views of the ECB and the NDA respectively. Whenever the NDA decides to apply measures provided under EU law[474] and aimed at addressing systemic or macroprudential risks, the NDA, ten working days prior to taking such a decision, shall notify its intention to the ECB. Where the ECB objects, it shall state its reasons in writing within five working days. The relevant NDA shall duly consider the ECB's reasons prior to proceeding with the implementation of its decision[475]. In turn, if the ECB deems it necessary it may instead of the relevant NDA apply higher requirements for capital buffers and apply more stringent measures aimed at addressing systemic or macroprudential risks. Where the ECB intends to make use of this power, it shall cooperate closely with the relevant NDA and, in particular, it shall notify its intention to the NDA ten working days prior to taking such a decision. Should the NDA objects to the activation of macroprudential tools as intended by the ECB, it shall state its reasons in writing within five working days. The ECB shall duly consider those reasons prior to proceeding with the decision as appropriate[476].

With regard to the ECB internal process to adopt macroprudential supervisory decisions, the latter does not follow the decision-making process set out under the SSMR for the exercise by the ECB of microprudential powers[477]. Indeed, the SSMR does not provide for a specific decision-making process for the exercise of macroprudential powers. Therefore, Article 13 h ECB Rules of Procedure[478] applies in respect of the activation of macroprudential powers. Article 13 h (1) applies if a NDA informs the ECB of its intention to apply macroprudential instruments. Following receipt of such notification by the Secretariat to the SB[479], it shall be transmitted to the GovC and the SB without delay. Upon a proposal prepared by the SB taking into account input from the MC and FSC[480],

[472] See ESRB (2018), p. 54.
[473] The measures might also be used for corporate and intra-financial exposures or loans denominated in foreign currency. See Napoletano (2014), p. 165.
[474] If a macroprudential measure as activated by the relevant NDA is not included in the EU legal framework (such as the LTV, LTI and DTI requirements), the monitoring and evaluation of its effects lie with the NDA within the broader cooperation framework with the ESRB. Article 5 SSMR would not apply.
[475] Article 5.1 SSMR.
[476] Article 5.2 and 5.4 SSMR.
[477] See Chapter 2, Paragraph IV.
[478] Decision of the European Central Bank of 19 February 2004 adopting the Rules of Procedure of the European Central Bank (ECB/2004/2) (2004/257/EC).
[479] For a discussion of the nature and composition of the SB, and its role within the SSM governance framework and the so-called 'non-objection procedure' in order to adopt microprudential supervisory decisions, see Chapter 2, Paragraph IV.
[480] The fact that the ECB internal structure responsible for carrying out qualitative and quantitative macroprudential supervisory work and preparing (in substance) draft proposals for the activation of macroprudential tools is embedded within the ECB monetary policy structure may raise doubts on the respect of the principle of separation with regard to

the GovC shall decide about the matter within three working days. In this way, ECB macroprudential decisions may also benefit from the SB's detailed knowledge of the Eurozone banking system and may help developing synergies between the two ECB bodies. If the GovC intends to objects to the measure proposed by the NDA, it shall explain its reasons in writing within five working days. In this context, it is of relevance that the GovC shall have i) the right to endorse, object to or amend[481] proposals of the SB, and ii) the right to request the SB to submit a proposal or to undertake specific analysis. If the SB submits no proposals addressing such requests, the GovC may take a decision in the absence of a proposal from the SB[482]. If the ECB intends to top up macroprudential measures adopted by the NDAs, the GovC, upon a proposal prepared by the SB taking into account input from the MC and FSC, such intention shall be notified to the concerned NDA at least ten working days prior to taking such a decision. If the concerned NDA notifies the ECB in writing of its reasoned objection within five working days of the receipt of the notification, this objection, upon receipt by the Secretariat to the SB, shall be transmitted to the GovC and SB without delay. The GovC shall decide on the matter on the basis of a proposal prepared by the SB, and this decision shall be transmitted to the relevant NDA. Again, the GovC, in this context, shall have i) the right to endorse, object to or amend proposals of the SB, and ii) the right to request the SB to submit a proposal or to undertake specific analysis. If the SB submits no proposals addressing such requests, the GovC may take a decision in the absence of a proposal from the SB.

the exercise by the ECB of macroprudential powers as set out under Article 5 SSMR. In this sense, see also Lackhoff (2017), p. 189.

[481] As discussed under Chapter 2, Paragraph IV, with regard to the adoption of microprudential supervisory decisions, the GovC is not entrusted with the power to change complete draft decisions but can only approve or object to them within ten days from submission by the SB.

[482] Article 13 h (3) ECB Rules of Procedure.

III. Supervisory Tasks and Powers Relating to the Supervision of Significant Supervised Entities

While in its legislative proposal the EC envisaged the transfer of direct supervisory tasks (and powers) in respect of all Eurozone banks, regardless of their business model or size[483], the ECB, following the establishment of the SSM, has been assigned with supervisory tasks (and powers) with regard to the on-going direct supervision of SIs[484], together with sanctioning powers[485]. The microprudential tasks centralised to the ECB are determined by Article 4.1 and 4.2 SSMR, whereas supervisory powers, in order to carry out the transferred tasks, are conferred to the ECB under Articles 9 to 18 SSMR. The ECB exercises its supervisory powers in respect of supervised entities only[486]. Further legal persons excluded from ECB supervision are the institutions referred to under Article 2.5 CRD IV and central counterparties[487]. In addition to supervised entities, however, also natural persons may be the addressees of supervisory decisions when the ECB exercises certain supervisory tasks (for instance, individuals may be the addressees of a qualifying holding decision). Pursuant to Article 4.1 SSMR, the ECB shall be '*exclusively competent*' to carry out for prudential supervisory purposes the tasks listed under Article 4.1 SSMR in relation to supervised entities established in the pMSs within the allocation of competences set out by Article 6 SSMR[488]. It is worth mentioning that Article 4.1 and 4.2 SSMR do not contain a conclusive list of tasks conferred to the ECB. Rather, such list expresses as a whole that the entire prudential supervision of SIs is assigned to the ECB, unless specific exceptions expressly apply[489].

3.1. Microprudential supervisory tasks

3.1.1. Pillar 1 and Pillar 3 prudential requirements

According to Article 4.1 (d) SSMR, one of the major tasks of the ECB is to ensure compliance with Pillar 1 prudential requirements in the areas of own funds[490], large exposure[491], securitization[492],

483 See EC (2012), para. 4.1.2. '*Scope of supervisory activities*'.
484 See Chapter 2, Paragraph 1.2.
485 The ECB-SSM sanctioning powers are discussed under Chapter 3, Paragraph IV.
486 Article 2 SSMR. For a reconstruction of the scope of operation of the SSM, see Chapter 2, Paragraph I.
487 Article 1 SSMR.
488 It follows that, if an NCA were to adopt a supervisory decision or a sanctioning measure against a SI that fall under the supervisory scope of the ECB, that decision or measure, in principle, should be void under national administrative law due to lack of competence.
489 In this sense, see Lackhoff (2017), p. 197. As Article 4.1 SSMR determines that the ECB shall be exclusively competent to carry out for prudential purposes '*the following tasks*', i.e. the tasks listed under Article 4.1, one could argue that only the tasks enumerated in the SSMR are transferred to the ECB. This would also seem to be in line with the principal of conferral under Article 5 TUE, as EU law would require a strict interpretation of the provisions transferring competences from the national level to the European level. On the other hand, transferring to the ECB only those tasks enumerated under Article 4.1 SSMR would result in a split of competence for the supervision of SIs between the ECB and the NCAs that is contrary to the objectives of the SSMR and that can potentially hamper the effectiveness of risk-based supervision. Therefore, under this interpretation of the SSM framework, the ECB is vested with tasks of direct prudential supervision relating to SIs unless such tasks are explicitly excluded from the conferral (such as AML/CFT supervision). For a similar interpretation of the SSMR, see also Bassani (2019), p. 56, who states that '*microprudential supervisory tasks entrusted to the ECB are very broad and basically all-encompassing*'.
490 Articles 25 to 386 CRR.
491 Articles 387 to 403 CRR.
492 With the aim to reviving the EU securitisation market and fostering investment opportunities, while establishing sound market practices to avoid financial disruption as in 2007-08, a revised EU securitisation framework has been laid down under Regulation (EU) 2017/2401 of the European Parliament and of 12 December 2017 amending Regulation (EU) No

liquidity[493], leverage[494], and public disclosure requirements[495]. These requirements stem from the substantive supervisory regulations that consist, in particular, of the CRR as EU implementation of the Basel standards. In addition, the ITS and RTS prepared by the EBA, and endorsed by the EC in the form of regulations, complement the applicable prudential supervisory law. Additional guidance follows from EBA Guidelines, if the ECB decides to comply. Although not legally binding, EBA Q&As often have a factually binding force[496].

The capital requirements shall ensure that the supervised entities hold certain levels of own funds against risks inherent to the business of the credit institution. The objective is to make banks more resistant to losses against financial crises and, thereby, to foster financial stability[497]. To this end, the CRR requires that the financial instruments representing the own funds of the bank comply with the Basel III standards to ensure their loss absorbing capacity[498]. Further, it requires that EU credit institutions hold the 8% capital to risk-weighted assets (**RWAs**) set out under the Basel framework[499]. The risk weighting of assets may either be carried out according to the standardised approach (**SA**) or the internal ratings-based (**IRB**) approach. Article 4.1 (d) SSMR covers also the assessment and the permission by the ECB to authorise banks to use alternative risk measurements approaches to the SA[500]. In order to ensure compliance with capital requirements, the ECB has the task of granting approvals, permissions, derogations, or exemptions foreseen for the purposes of those EU primary and secondary rules. Accordingly, the ECB is, for example, competent to decide on applications for the reduction, repayment or redemption of own funds instruments under Article 77 and 78 CRR[501]. Such permissions need to be adopted in the form of supervisory decisions under the applicable decision-making procedure, i.e. the non-objection procedure or the delegation procedure[502].

EU prudential rules on securitisations cover two dimensions. The first dimension relates to credit institutions making use of securitisations in order to reduce own funds which covered for the securitised exposures. In this regard, the core question is whether a significant credit risk transfer is achieved[503]. The other dimension relates to the role of credit institutions as investors. As investor, the credit institution needs to determine the amount of own funds to be held for the acquired securitised exposure. Under this perspective, Regulation 2401 stipulates what criteria securitised positions in the

575/2013 on prudential requirements for credit institutions and investment firms (the '**Regulation 2401**'). Regulation 2401 lays down the substantive elements of an overarching EU securitisation framework, with criteria to identify simple, transparent and standardised securitisations and a system of supervision to monitor the correct application of those criteria by originators, sponsors, issuers and institutional investors. Furthermore, Regulation 2401 provides for a set of common requirements on risk retention, due diligence and disclosure for all financial services sectors. As a consequence, Articles 404 to 410 CRR have been repealed and the ECB will ensure compliance by supervised entities with securitisation requirements in accordance with the provisions laid out by Regulation 2401.

493 Article 411 to 428 CRR.
494 Article 429 to 430 CRR.
495 Article 431 to 455 CRR.
496 See Lackhoff (2017), p. 198.
497 See Gortsos (2015), p. 143. For an overview of the components of the capital base of credit institutions, see Chapter 1, Paragraph II.
498 Articles 25 to 91 CRR.
499 Article 92 CRR.
500 The possibility to use, subject to prior supervisory approval, alternative risk models to the calculation of capital requirements was introduced for the first time by the Basel II Accord. See Chapter 1, Paragraph 1.4.
501 See Chapter 3, Paragraph 2.2.
502 See Chapter 2, Paragraph IV.
503 Articles 242 to 270 CRR.

context of simple, transparent and standardised securitisations, as well as in synthetic securitisations, need to fulfil in order to be acquired by banks.

The ECB is also competent to supervise whether credit institutions comply with large exposure requirements. The purpose of large exposure requirements is to avoid risk concentration. In this regard, the CRR II aligns the EU framework to the Basel standards[504], as it sets out that EU banks cannot have in the banking book a total exposure value towards a single counterparty that is higher than 25% to their Tier 1 capital (the CRR I made reference to the eligible capital base as denominator). In addition, the CRR specifies that in case the single exposure is towards another bank (or an investment firm), that value shall not exceed 25 % of the bank's eligible capital or EUR 150 million, whichever the higher value. In line with the Basel framework, when the total exposure value is calculated between two G-SIBs, the large exposure requirements is reduced to 15%[505].

The task to ensure compliance with liquidity requirements relates to the two liquidity buffers envisaged in the CRR. In line with the Basel framework, these are the liquidity coverage ratio (**LCR**) and the net stable funding ratio (**NSFR**)[506]. The EU implementation of Basel III in 2013 through the CRD IV package introduced binding requirements only in relation to the LCR. The NSFR has been introduced as a binding prudential ratio by the CRR II[507] with starting date of application as at 28 June 2021[508]. As mentioned in Chapter 1, the NSFR complements the LCR, as the LCR focuses on short term liquidity risk, while the NSFR targets longer term funding risk of institutions[509]. The NSFR aims to discourage excessive maturity and/ or liquidity transformation, limit overreliance on short term wholesale funding and promote funding stability and sustainable balance sheet expansions. The NSFR under the CRR II applies both at solo and consolidated level[510]. As the NSFR is a complex requirement to meet for banks, due to the fact that it forces institutions to structurally rearrange their funding mechanisms and operations on wholesale funding markets, EU regulators, under pressure from the industry, decided to implement it only in the context of the CRD V package review[511]. In this sense, the CRR II NSFR has been calibrated with a view to avoiding disruption, in particular, to EU covered bond, derivatives and repo markets, with discrete divergences from the international standard[512].

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504 Article 395.1 CRR
505 Article 395.1 CRR.
506 For a description of the structure and objectives of these two liquidity requirements, see Chapter 1, Paragraph 2.3.
507 Article 428b CRR. For a thorough discussion of the CRD V package, see Chapter 3, Paragraph 1.2.
508 Until then, national stable funding requirements may be introduced or maintained by EU Member States. See Article 413.4 CRR.
509 According to Article 428b CRR, the NSFR requirement is the ratio between available stable funding and required stable funding and shall be at least 100% at all times.
510 Article 6.4 and 11.4 CRR.
511 According to Article 428b CRR, if the NSFR is below or expected to fall below 100%, the credit institution shall immediately notify its supervisor and restore the ratio in a timely manner. The supervisor shall consider supervisory measures on a case-by-case basis, while paying specific attention to the cause of non-compliance. Until the NSFR has been restored, the credit institution shall report the NSFR on a daily basis to the supervisor. The supervisor may decide that less frequent reporting is appropriate (Article 414 CRR).
512 The main regulatory differences relate to the application of the stable funding factors to i) Level 1 assets, which under the CRR II do not require the application of a stable funding factor (except for Level 1 covered bonds), whereas under the Basel framework they require a stable funding factor set at 5%, and ii) the treatment of short-term (less than 6 months) lending transactions with financial customers, which under the CRR II require lower stable funding factors compared to the Basel III framework.

The CRR II also introduces the Basel III leverage ratio as an own funds binding requirement[513]. As discussed under Chapter 1[514], if an entity's assets exceed its capital base, it is leveraged. This is an inherent element of banking. To constraint excessive leverage, the CRR II leverage ratio requires banks to maintain a non-risk based 3% ratio of Tier 1 capital to total exposures[515]. In addition, G-SIIs (and, hence, G-SIBs) are required to hold a leverage ratio surcharge in the form of a buffer, calibrated at 50% of the G-SII buffer rate[516]. Unlike the Basel framework, however, the CRR II allows initial margin to reduce the exposure measure when applying the leverage ratio to derivatives.

Further, the ECB has also the task to review whether supervised entities comply with Pillar 3 disclosure requirements[517]. Banks are required to publish, on an annual basis, information relating to, *inter alia*, their level of own funds and liquidity buffers, the leverage ratio, their corporate structure and remuneration policies.

3.1.2. Pillar 2 prudential requirements

According to Article 4.1 (e) SSMR, a further major microprudential task centralised to the ECB in respect of SIs is to ensure compliance with governance and risk management requirements. These requirements form the Pillar 2 of the current supervisory framework (as established by the Basel II Accord). This task covers in particular compliance by supervised entities with robust governance arrangements, including the fit and proper requirements for the persons responsible for the management of credit institutions[518], risk management processes[519], internal control mechanisms[520], remuneration policies and practices[521] and effective internal capital adequacy assessment processes[522], including IRB models. As Pillar 2 requirements, in contrast to Pillar 1 requirements, are established in the CRD IV, the ECB has to apply the national law implementing such Directive. The mere fact of 19 diverging implementations can impose a substantial burdening on the ECB[523].

Under this perspective, particular challenges are posed by fit & proper assessments[524], as these assessments are based on the national laws implementing Article 91 CRD IV. While a growing body of academic research shows that corporate governance and board suitability can play a crucial role in improving bank risk-taking and financial stability[525], EU law on the fitness and propriety of banks' management bodies is based on a set of high-level principles that were conceived before the Banking Union, in a context were supervision was still predominantly national[526]. In particular, the CRD IV

[513] Article 92.1 (d) CRR.
[514] See Chapter 1, Paragraph 2.2.
[515] Under the CRR I, the leverage ratio was introduced solely as a reporting and disclosure requirement.
[516] Article 92.1 (a) CRR.
[517] Articles 431 to 455 CRR.
[518] Article 91 CRD IV.
[519] Articles 74 to 87 CRD IV.
[520] Article 4.5 and 123 CRD IV.
[521] Articles 74.1, 75, 92 to 96 CRD IV.
[522] Articles 73 and 108 CRD IV.
[523] In this sense, see Lackhoff (2017), p. 200.
[524] According to the 2019 ECB annual report on supervisory activities, in 2019 the ECB issued a total number of 2,356 supervisory decisions addressed to supervised entities. Of these, fit and proper assessments amounted to almost half of the total number (47.3%), followed by SREP decisions (8.6%), internal models (7.5%), own funds (7.0%), and qualifying holdings (5.5%) procedures. See ECB (Mar 2019).
[525] A comprehensive survey on bank governance and performance can be found in Fernandes et al. (2018).
[526] See Resti (2020).

sets out five different criteria against which the supervisory assessment is to be carried out: i) knowledge, skills and experience, ii) good standing (reputation), iii) sufficient time commitment, iv) potential conflicts of interest, and v) the adequate knowledge, skills and experiences of the management body[527]. Further, ECB fit & proper assessments are based on the joint EBA-ESMA Guidelines[528] and SSM policy[529]. Fit & proper assessments are carried out by the ECB in respect of all supervised entities in the context of the authorisation procedure or the acquisition of a qualifying holding (in case one or more members of the management of the target institution would be substituted). If a bank's board member is appointed outside the context of common procedures, for instance because of a renewal of his or her position[530], or due to new facts[531], the ECB remains competent for SIs, while NCAs are competent for LSIs.

As applicable requirements for fit & proper assessments are not fully EU-harmonised, relevant challenges exist on the side of the ECB-SSM to ensure a level playing field in this area. Significant legislative differences exist in pMSs, which affect both procedural and substantive aspects. First, as far as the former is concerned, some pMSs require *ex-ante* decisions – meaning that supervisory evaluations must be carried out before an appointment is effective – while other pMSs provide for *ex-post* evaluations, to be performed after appointees have become members of the management body[532]. This difference is not only procedural, but also has wide-ranging consequences for the quality and timeliness of fit and proper decisions.

Under a substantial perspective, the main supervisory challenges on the side of the ECB-SSM relate to: i) the application of the independence requirement to supervised entities' board members, ii) the good standing (reputation) criterion, and iii) the scope of assessment for 'key function holders'[533]. First, deep segmentations exist across SSM country-specific definitions of 'independence' with regard to banks' board members, as not all SSM jurisdictions decided to comply with this requirement provided under the Joint Guidelines[534]. As the principles stated in the Joint

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[527] Article 91.1, 91.2, 91.7 and 91.8 CRD IV.
[528] Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU, EBA/GL/2017/12, 26 September 2017 (the '**Joint Guidelines**').
[529] See *ECB Guide to fit and proper assessments*, May 2017.
[530] Article 93.1 FR.
[531] Article 94 FR.
[532] According to the former SSM Chair, in principle all fit and proper assessments should be carried out *ex-ante*, that is before the candidate is appointed and takes up the new function. However, only half of all NCAs perform *ex-ante* suitability assessments. The other half only performs them *ex-post*. From a prudential point of view, advance assessments are more effective in ensuring that banks are governed soundly and prudently. They minimise the risk that banks are badly managed by unsuitable managers, which has been one of the negative factors that contributed to the outbreak of the GFC. In addition, *ex-post* assessments might lead to situations where members of the management body would have to be removed after their appointment. This would be bad for the reputation of the bank. See Nouy (2018). In addition, deadlines for final decisions vary significantly across countries, ranging from 30 days to no deadline at all. The possibility of suspending/interrupting the assessment process is also regulated by national law. See ECB (2018).
[533] Under para. 15 Joint Guidelines, key function holders are defined as '*persons who have significant influence over the direction of the institution, but who are neither members of the management body and are not the chief executive officer. They include the heads of internal control functions and the chief financial officer, where they are not members of the management body, and, where identified on a risk-based approach by credit institutions, other key function holders. Other key function holders might include heads of significant business lines, European Economic Area/European Free Trade Association branches, third country subsidiaries and other internal functions*'.
[534] While the CRD IV is silent on the requirement for independent directors, the joint Guidelines (para. 88-93) set out that significant credit institutions (in the meaning of Article 131 CRD IV) and listed credit institutions should include a sufficient number of fully independent members in the management body in its supervisory function. Further, credit

Guidelines (and ECB guide) are not binding and cannot override national law, the ECB is called to apply different standards for banks headquartered in different pMSs. Second, rules on honesty and integrity also involve significant dissimilarities, as the same behaviour may constitute a criminal offence or an administrative irregularity in different jurisdictions. Such differences blur the regulatory landscape, making it easier for appointees to challenge the ECB's views (above all in countries where the presumption of innocence has constitutional dignity)[535].

Finally, the Joint Guidelines introduced also the concept of 'key function holders', and required credit institutions to assess their suitability. With regard to SIs, the ECB-SSM is, therefore, called to assess the suitability of the heads of internal control functions or the chief financial officer, if they are not part of the management body[536]. However, significant differences remain in the scope of the individuals to be assessed, as there is no definition of key function holders in the CRD IV. Therefore, the ECB has to carry out fit & proper assessments with regard to key function holders appointed by SIs on the basis of national regulatory frameworks, which differ in scope and applicable criteria. In addition, not all pMSs decided to comply with the requirements of the Joint Guidelines on key function holders. For instance, Bafin in Germany and ACPR in France communicated to EBA and ESMA their intention not to comply with this requirement. Therefore, in several SSM jurisdictions, the appointment of key function holders is not subject to supervisory assessment as national law does not provide for the appropriate legal basis. This lack of regulatory harmonisation in EU primary and secondary legislation as regards fit & proper assessments greatly fosters fragmentation in the SSM prudential level playing field and impose a substantial burdening on the single supervisor[537].

3.1.3. The SREP and stress testing

According to Article 4.1 (f) SSMR, a further major task entrusted to the ECB is conducting supervisory reviews, and imposing on credit institutions, on the basis of such ad-hoc supervisory

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institutions that are neither significant nor listed should, in the view of EBA-ESMA, have at least one independent member within the management body in its supervisory function. Under the Joint Guidelines, a board member can be regarded as 'independent' if he or she does not have any present or recent past relationships or links of any nature with the credit institution or its management that could influence the member's objective and balanced judgement and reduce member's ability to take decisions independently. It is presumed that a board member is not regarded as 'being independent' if such a member is employed by any entity within the scope of consolidation (para. 91). Under the Joint Guidelines, the independence requirement is clearly differentiated from the notion of 'independence of mind', which is a requirement set out under Article 91.12 CRD IV and, therefore, applicable to all members of a supervised entity's management body. Against this backdrop, it has been argued that the two ESAs have exceeded their mandate by issuing guidelines that introduced, even if in a non-binding fashion, the requirement for banks to appoint independent directors, as such fit & proper requirement is not provided for under the CRD IV. As compliance with EBA-ESMA Guidelines is subject to the 'comply or explain' mechanism, several NCAs (such as Bafin in Germany or the Central Bank of Belgium) have decided not to comply with the independence requirement of the Joint Guidelines. Therefore, in such jurisdictions, the inclusion of independent directors in the management body of a bank is not a legal requirement.

[535] See Resti (2020), p. 19.

[536] As noted in legal scholarship, the extension of the formal suitability regime to such key function holders appears problematic. While in some jurisdictions, such as the UK, it is a well-established practice that fit and proper requirements also relate to certain individuals below board level, in other European jurisdictions, such as Germany, a formal suitability assessment by the authorities is in principle only foreseen for members of the management board or the supervisory board. Furthermore, the CRD IV does not contain any provision that would require EU Member States to implement an administrative assessment of such key function holders. For a critical analysis of the fit & proper regime within the SSM, see Wundenberg (2018).

[537] For an empirical analysis of the trends in size and composition of SIs' boards during the period 2011-2018, see Bertay and Huizinga (2020).

reviews, specific additional qualitative or quantitative requirements. Supervisory reviews represent the core of the second pillar of the Basel framework and are all reviews carried out in order to determine whether arrangements, strategies, processes and mechanisms put in place by credit institutions and the own funds held by them ensure a sound management and coverage of their risks. This task is fulfilled in particular through the supervisory review and evaluation process (**SREP**)[538] envisaged by Article 97 CRD IV which provides for an annual comprehensive review of the arrangements, strategies, processes and mechanisms implemented by a credit institution to comply with EU supervisory law. As a result of the SREP, the ECB may impose specific additional capital or liquidity buffers on credit institutions, or may make use of selected supervisory powers provided under EU prudential legislation (such as the power to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements[539], or the power to impose additional or more frequent reporting requirements[540]) to address emerged risks and deficiencies in the viability and sustainability of the business model of the relevant SI.

The meaning of supervisory reviews, however, is not limited to the annual SREP process. Rather, any other review carried out for prudential purposes and to inform the ECB supervisory action is also a supervisory review. For instance, thematic reviews are used by the ECB to assess a current or emerging risk relating to an issue or product across a number of banks within a certain market. Thematic reviews usually aim at both identifying current supervisory issues, and assessing the main trends in the relevant market, with a view to providing potential solutions to address these issues[541]. Supervisory reviews (including thematic reviews) may include the use of investigatory powers by the ECB.

A stress test is also a supervisory review[542]. A stress may be initiated and coordinated by the EBA[543], in cooperation with the ESRB, or be carried out by the competent supervisor[544]. The EBA EU-wide stress test exercise is primarily a diagnostic tool focused on the assessment of the impact of adverse shocks on the solvency of banks. Banks are required to estimate the evolution of a common set of risks (credit, market, counterparty and operational risk) under an adverse scenario. Additionally, banks are requested to project the impact of the scenarios on the main income sources.

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[538] For a thorough analysis of the ECB-SSM SREP, see Chapter 3, Paragraph III.
[539] Article 16.2 (d) SSMR.
[540] Article 16.2 (j) SSMR.
[541] An example of ECB thematic reviews is the 2018 ECB-SSM report '*The SSM thematic review of profitability and business models – Report on the outcome of the assessment*', in which the ECB assessed SIs' business models with a view to determining the main causes for weak banking profitability in the Euro area. See ECB (Sep 2018). Such report is discussed in detail under Chapter 4, Paragraph 1.3.
[542] It is worth mentioning that only after the GFC supervisory stress tests have become an effective tool at disposal of prudential authorities, leading the BCBS and the CEBS to issue the '*Principles for sound stress testing practices and supervision*' (2009) and the '*Guidelines on Stress Testing*' (2010) in order to harmonize the stress testing framework among banks and NCAs. Under Basel II and prior to the outbreak of the GFC, supervisory stress tests had not yet been developed as a supervisory tool to assess a bank's resilience to withstand hypothetical and adverse scenarios. Stress tests were rather conceived as a bank risk management tool, to be developed under both Pillar 1 (to ensure the robustness of the validated internal model for IRB banks) and Pillar 2. However, the Basel II framework lacked a clear set of recommendations for stress testing practices (e.g. scenario selection, risk coverage, integration in risk governance, IT infrastructure), leaving most of the choices to the banks' discretion. See Bevilacqua et al. (2019).
[543] Article 22.1a, and Article 32 EBA Regulation. The EBA Regulation provides also for the right on the side of the EBA to publish the results. For supervisory authorities, Article 53.3 CRD IV clarifies that professional confidentiality shall not prevent them from publishing the outcome.
[544] Article 100 CRD IV.

The key objective of the EBA EU-wide stress test, which is carried out every two years, is to provide supervisors, banks and other market participants with a common analytical framework to consistently compare and assess the resilience of EU banks and the EU banking system to shocks, and to challenge the capital position of EU banks. In particular, EBA EU-wide stress test is designed to inform the SREP carried out by competent supervisory authorities[545]. The exercise is based on a common methodology, consistent relevant scenarios and a set of templates that capture starting point data and stress test results to allow a rigorous assessment of the banks in the sample. The EBA EU-wide stress tests are conducted in a bottom-up fashion, using consistent methodologies, scenarios and key assumptions developed in cooperation with the ESRB, ECB and EC. According to the EBA methodology to conduct the 2021 EU-wide stress tests[546], the exercise will be carried out on a sample of banks covering broadly 70% of the banking sector in the euro area, each non-euro area EU Member State and Norway, as expressed in terms of total consolidated assets as of end 2019. To be included in the sample, banks have to have a minimum of EUR 30 billion in assets[547]. The exercise will be carried out on the basis of year-end 2020 figures, and the scenarios will be applied over a period of 3 years from end-2021 to end-2023. The impact of the EU-wide stress test will be reported in terms of CET1 capital. In addition, the Tier 1 capital ratio and total capital ratio, as well as the leverage ratio, will be reported for every year of the exercise[548]. The EBA aims at publishing the results of the EU-wide stress test by end-July 2021.

From its side, the ECB carries out stress tests under at least three different circumstances[549]. First, in years when there is no EU-wide EBA stress test, the ECB tests SIs against a selected kind of shock. These tests are run in cooperation with the NCAs and the results are usually published on an aggregate basis. Second, ECB stress tests are one of the two pillars of the comprehensive assessment, which is a financial health check that helps to ensure banks have enough capital to withstand possible financial shocks. Comprehensive assessments are carried out either when i) a bank is classified as significant and will from then on be supervised directly by the ECB, ii) close cooperation is established between a non-euro area EU Member State and the ECB, or iii) on a case-by-case basis, when such an assessment is prompted by exceptional circumstances. Third, the ECB also conducts stress tests for macroprudential and financial stability purposes. Such stress tests tend to focus on system-wide effects rather than on individual banks and are run in a top-down manner (without the involvement of the banks). The results are regularly published in the ECB Financial Stability Reviews and Macroprudential Bulletins.

3.1.4. Consolidated supervision

In order to ensure adequate supervision of groups to which also a credit institution belongs, the CRD IV establishes the concept of supervisory colleges as a mean to coordinate the supervision of a

[545] See EBA (Nov 2020b), p. 12.
[546] See EBA (Nov 2020b).
[547] The EUR 30 billion materiality threshold is consistent with the criterion used for inclusion in the sample of banks reporting supervisory reporting data to the EBA, as well as with the SSM definition of SI. See Chapter 2, Paragraph 1.2.
[548] See EBA (Nov 2020b), p. 15.
[549] ECB stress tests are based on the EBA stress test methodology, but they can be adapted to take into account bank-specific circumstances (such as in the case of comprehensive assessments).

group with entities established in different Member States by the relevant NCAs[550]. The SSMR entrusts the ECB with carrying out the supervision on a consolidated basis if the ECB is the consolidating supervisor[551] and the supervised group is significant[552]. If the ECB is the consolidating supervisor, it is also the authority appointed to establish the college of supervisors[553]. If the ECB is not the consolidating supervisor but a credit institution supervised by it is part of a group for which the consolidating supervisor has established a college, it is part of the tasks of the ECB to participate in this college. If, in addition to a SI supervised by the ECB, also one or more LSIs supervised by NCAs are part of the group, also the NCAs are members of the college as well[554]. Article 17.2 SSMR clarifies that for groups established only in pMSs no college is established. While supervisory colleges have no powers vis-à-vis the supervised entities forming the group which is subject to consolidated supervision, they shall adopt joint decisions to determine the adequacy of the consolidated level of own funds and liquidity[555]. Such joint decisions must be implemented by supervisory decisions of the relevant NCA in order to create legal obligations vis-à-vis supervised entities.

3.1.5. Supplementary supervision of financial conglomerates

According to Article 4.1 (h) SSMR, it is a further task of the ECB to participate in the supplementary supervision of conglomerates and to carry out the task of coordinator if it is appointed so in accordance with EU supervisory law[556]. Financial conglomerates are groups active in the financial sector with at least one entity from the insurance sector and one from the banking sector[557]. A financial conglomerate can only be a supervised group if the coordinator is a banking supervisor, as appointed pursuant to Article 10 FICOD[558]. In this case, the ECB may be the coordinator for the conglomerate.

[550] Article 116 CRD IV.
[551] Article 111 CRD IV.
[552] Article 8 FR.
[553] Article 116 CRD IV, Article 9 FR.
[554] This can occur if there is no level of consolidation within pMSs covering all banks. If the UK credit institution (A) owns a LSI (B) in Belgium, and a SI (C) in France, the ECB will be part of the college in respect of (C), while the Belgian NCA will be part of the college for (B). See Lackhoff (2017), p. 203.
[555] Article 113.1 CRD IV.
[556] As mentioned in Chapter 1, the deregulation of domestic financial markets that occurred during the 1980s, together with the internationalisation of financial markets, led to new ways and means of doing business in the increasingly globalized and integrated world economy. Since then, one notable development has been the emergence of financial conglomerates, which can be defined as any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance). Financial conglomerates emerged ever more in the last forty years and are often characterised by significantly large balance sheets (and off-balance-sheet positions), while they usually provide a wide range of financial services in a variety of geographic locations. Many of the challenges to be encountered in the supervision of financial conglomerates would also arise in the case of 'mixed conglomerates', which offer not only financial services (perhaps restricted to just one of the three sectors mentioned above), but also non-financial or commercial services. For an in-depth discussion on the origins of the financial phenomenon of conglomerates and the significant supervisory challenges it poses, particularly as regards capital adequacy, see BCBS, IOSCO and IAIS (1995).
[557] Article 2.14 FICOD.
[558] According to Article 10 FICOD, in case a financial conglomerate is headed by a regulated entity, the task of coordinator shall be exercised by the competent authority which has authorised that regulated entity pursuant to the relevant sectoral rules. In case a financial conglomerate is not headed by a regulated entity, the task of coordinator shall be exercised by the competent authority identified in accordance with the following principles: i) where the parent of a regulated entity is a mixed financial holding company, the task of coordinator shall be exercised by the competent authority which has

When participating in the supplementary supervision the ECB may, among others, be involved in determining whether certain undertakings may be excluded from the calculation of capital adequacy requirements[559] and in reassessing waivers from the application of supplementary supervision[560].

3.1.6. Recovery planning and early intervention measures

Finally, the ECB is entrusted with the task to carry out supervisory tasks in relation to i) recovery plans, and ii) early intervention where a SI does not meet or is likely to breach the applicable prudential requirements so far discussed[561]. The scope of the ECB supervisory power in relation to recovery relates to the assessment and approval of recovery plans submitted by SIs to the supervisor. The ECB may require the credit institution to submit a revised plan by making use of the power under Article 6.5 BRRD. The ECB may also adopt the early intervention measures set out under Articles 27 to 30 BRRD in case a SI does not meet or is likely to breach the applicable prudential requirements due, *inter alia*, to a rapidly deteriorating financial condition, including deteriorating liquidity situation, increasing level of leverage, non-performing loans or concentration of exposures, as objectively assessed by the supervisor on the basis of a set of triggers. In this sense, the adoption of such measures is required against a significant deterioration in the financial situation of an institution or where there are serious infringements of law[562]. However, certain early intervention measures cannot be differentiated from supervisory measures, as some of the early intervention measures laid down under Article 27 BRRD overlap with the ECB supervisory powers under Article 16 SSMR. This shows that the BRRD early intervention measures are, in fact, supervisory measures[563]. It can be argued, therefore, that the categorisation between early intervention measures and supervisory measures could be substituted from the application of the principle of proportionality, that is more severe measures, such as the removal of board members, would require a more deteriorated financial situation in the credit institution.

The third task envisaged under Article 4.1 (i) SSMR is a placeholder. It ensures that, when enabled by EU legislation, the ECB may have the power to implement structural changes in the corporate structure of banks and separate certain business activities with a view to preventing financial stress or failure. However, the imposition of ring-fencing (in particular, with regard to investment banking activities from deposit taking) is not a prudential power currently entrusted by the SSMR or Union law to the ECB[564].

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authorised that regulated entity pursuant to the relevant sectoral rules; ii) where at least two regulated entities which have their registered office in the Union have as their parent the same mixed financial holding company, and one of those entities has been authorised in the Member State in which the mixed financial holding company has its head office, the task of coordinator shall be exercised by the competent authority of the regulated entity authorised in that Member State.

[559] Article 6.5 FICOD.

[560] Article 3.9 FICOD.

[561] Article 4.1 (i) excludes that the ECB may exercise any further resolution powers in addition to those expressly mentioned under the SSMR, i.e. approval of recovery plans, adoption of early intervention measures and adoption of the failing or likely to fail assessment. The term '*resolution powers*' is defined, at EU level, under Article 2.20 BRRD. For a discussion of the ECB-SSM resolution powers, see Chapter 3, Paragraph IV.

[562] Article 28 BRRD.

[563] See Lackhoff (2017), p. 205.

[564] On the challenges to centralise to the ECB the supervisory power to impose the structural separation between the retail and investment banking business, see Bassani (2019), p. 126 ff.

3.2. Microprudential supervisory powers

3.2.1. Conditions for the adoption of microprudential supervisory powers

Article 16 SSMR is the core supervisory power used for supervisory measures by the ECB. In addition, as discussed, the ECB has the powers granted to NCAs under national prudential law[565]. According to Article 16.1 SSMR, the ECB can adopt any of the measures falling under the second paragraph of that Article if i) the SI does not meet the prudential requirements laid out under EU banking supervisory law, ii) the ECB has evidence that the credit institution is likely to breach the prudential requirements laid out under EU banking supervisory law within the next 12 months, and iii) the arrangements, strategies, processes and mechanisms implemented by the SI and the own funds and liquidity held by it do not ensure a sound management and coverage of its risks, based on the ECB supervisory assessment carried out in the context of a supervisory review in the meaning of Article 4.1. (f) SSMR[566].

In practice, the ECB is entrusted with a rather broad margin of discretion as to when make use of microprudential supervisory powers, as in principle every breach or likely breach of the CRR, the national prudential law implementing the CRD IV, and other purely national prudential provisions can be the basis for the adoption of any measure under Article 16.2 SSMR. Accordingly, a strict proportionality review must be carried out, as ECB measures need to be suitable and necessary in respect of their objective[567]. In this sense, when making use of microprudential supervisory powers, the ECB must justify to the relevant SI(s), based on the existing factual situation, which prudential requirements are not met, and why. In case of application of microprudential supervisory powers following a supervisory review (such as the SREP), the ECB shall also explain why the current situation of the relevant SI(s) does not ensure a sound management and coverage of risks.

The list of powers under Article 16.2 SSMR resembles Article 104 CRD IV, as the only difference is the additional power set out under Article 16.2 (m) SSMR to remove members from the management body of the bank. However, by being part of a directly applicable Regulation, Article 16 SSMR subjects the application of these measures only to the conditions of Article 16.1 SSMR. Would the ECB take recourse to the powers in national law which are implementing Article 104 CRD IV (which are available through Article 9.1 (3) SSMR), the ECB would have to comply with the conditions laid down under national law, which may be different and more restrictive than the scope of Article 16.1 SSMR. Consequently, the ECB would not usually resort to the powers listed under Article 104 CRD IV, being in the position to directly apply those measures listed under Article 16.2 SSMR. In this sense, Article 16 SSMR is the vital supervisory power employed by the ECB for supervisory interventions[568].

3.2.2. Microprudential supervisory powers granted to the ECB

Article 16.2 (a) grants the power to the ECB to require supervised entities to hold own funds in excess of the capital requirements laid down in the CRR and CRD IV (the so-called 'capital add-

[565] Article 9.1 (3) SSMR. For a discussion of this provision of the SSMR, see Chapter 2, Paragraph 1.1.
[566] See Chapter 2, Paragraph 3.1.3. Under most circumstances, such ECB supervisory review will be the annual SREP.
[567] See Lackhoff (2017), p. 206.
[568] *Ibid.*, p. 206.

ons') in respect of elements of risks and risks not covered by EU legislation. An example for the latter case would be a concentration in exposures to sovereign debtors. The main example for the former case would be the Pillar 2 capital add-ons imposed in the context of the SREP.

Article 16.2 (b) provides the ECB with the power to require the reinforcement of the internal arrangements, processes, mechanisms and strategies of SIs. This power assumes particular relevance if the SREP or on-site inspections reveal weaknesses in the governance and risk management governance of the bank.

Further, the ECB may require credit institutions to present a plan to restore compliance with EU prudential supervisory requirements, the national law implementing EU prudential legislation, as well as purely national prudential provisions, and set a deadline for its implementation, including improvements to that plan regarding scope and deadline[569].

The ECB may require SIs to apply a specific provisioning policy or treatment of assets in terms of own funds requirements. This provision must be interpreted against the lack of mandate by the ECB in respect of accounting[570]. In this context, the first power set out under Article 16.2 (d) SSMR ('*require to apply a specific provisioning policy*') does not grant the power to the ECB to make specific provisions. Rather, it centralises to the ECB the power to require SIs to implement changes to their general provisioning approach within the applicable accounting framework. Therefore, the ECB may require the relevant SI to apply election rights in a certain manner[571]. The second supervisory power ('*require to apply a treatment of assets in terms of own funds requirements*') provides the ECB with the power to require banks to treat specific assets, either under the SA or the IRB approach, according to a specific risk measurement methodology for the purposes of calculating minimum capital levels. An example deriving from the application of this supervisory power would be the request by the ECB to reclassify a certain exposure in a different asset class or to set higher risk weights[572]. Additionally, this power can be interpreted as providing the ECB to apply regulatory adjustments (i.e. deductions) from own funds with regard to specific assets (usually, that would be in respect of certain items classified as CET1 capital, such as goodwill).

According to Article 16.2 (e) SSMR, the ECB is entitled to restrict or limit the business, operations or network of institutions or to request the divestment of activities that pose excessive risks to the soundness of an institution. Under this provision, not only specific types of activities but also specific

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[569] As discussed in the previous Paragraph, the supervisory powers listed under Article 16.2 SSMR are available to the ECB also in case the relevant SI is likely to breach prudential requirements within the next 12 months. Thus, the power of the ECB to require banks to present a restoration plan may be used also in case the breach of prudential requirements does not exist yet, but it is '*likely*' to occur. In this sense, the indent '*to restore compliance*' under Article 16.2 (c) SSMR should be read in the meaning of '*to ensure compliance*'.
[570] See Recital 19 SSMR.
[571] See Lackhoff (2017), p. 208.
[572] The (microprudential) supervisory power listed under Article 16.2 (d) SSMR partially overlaps with the macroprudential power entrusted to the ECB to set higher risk weights than those set out under Article 125.2 and 126.2 CRR in relation to exposures fully secured by mortgages on residential or commercial immovable property, respectively (see Chapter 2, Paragraph 2.3.1.). As the decision-making processes with regard to the adoption of microprudential or macroprudential decisions are clearly different under the SSM framework, one may assume that, as long as a certain supervisory power in respect of the treatment of assets in terms of own funds requirements under the CRD package is not expressly referred to by Article 5 SSMR and, therefore, classified as 'macroprudential', the ECB may resort to the application of the microprudential power under Article 16.2 (d) SSMR.

transactions can be restricted or even interdicted[573]. However, the ECB cannot go as far as to require banks to implement structural changes in their corporate structure and ring-fence certain business activities (such as investment banking activities from deposit taking)[574]. As such supervisory measure is particularly intrusive in the operations of the bank and vis-à-vis its management body, the ECB is subject to a strict proportionality test in the application of Article 16.2 (e) SSMR and must provide the relevant SI, when making use of such power, with a trade-off analysis that would compare the potential losses that will occur should the risks materialise and the probability of the risks turning into reality.

Furthermore, the ECB may require the reduction of the risk inherent in the activities, products and systems of institutions. Similarly to the supervisory measure under Article 16.2 (e) SSMR, also Article 16.2 (f) SSMR is subject to a strict proportionality test and requires the ECB to provide the credit institution with reasonable evidence why such risks are not sustainable. As several possibilities reduce risk may exist, the ECB must also carefully choose the specific measure and may even leave the means to achieve a certain reduction in risk to the relevant SI.

Article 16.2 (g) and Article 16.2 (h) SSMR vest the ECB with the interconnected powers to require banks to use net profits to strengthen own funds, and to limit distributions of net profits to shareholders, respectively. An example deriving from the application of the Articles is the request by the ECB to apply limitations to variable remuneration as a percentage of net revenues, when such remuneration is inconsistent with the maintenance of a sound capital base. This power must be interpreted as going beyond the cases where the CRD IV provisions on the maximum distributable amount (**MDA**) apply[575]. Accordingly, Article 16.2 (g) and Article 16.2 (h) SSMR can be exercised at an early stage when with regard to the reasonably expected future development of the supervised entity such a limitation of variable remuneration to a certain percentage of expected net profits is proportional. Consequently, these are supervisory powers directed to preventive capital protection[576].

In parallel to the previous two letters, Article 16.2 (i) SSMR enables the ECB to temporarily restrict or prohibit distributions by the institution to shareholders and holders of AT1 instruments (in the latter case, where the prohibition does not constitute an event of default of the issuer). This power can be exercised at an early stage if based on the reasonably expected future deterioration of the capital position of the supervised entity, which may put at risk the bank of not meeting CRR minimum capital requirements. Since the exercise of this power is based on a prognosis, the ECB needs to provide the bank with an assessment based on a solid methodological approach and sound factual elements[577].

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573 This view is supported by the fact that the intervention with regard to a specific activity/transaction is less burdensome than with regard to a type of activity/transaction. See Lackhoff (2017), p. 208.

574 As discussed under Chapter 2, Paragraph 3.1.6., this is a supervisory power currently not entrusted to the ECB by the SSMR or Union law.

575 For a discussion of the MDA prudential trigger, see Chapter 3, Paragraph 4.1.

576 See Lackhoff (2017), p. 208.

577 This power has been recently exercised by the ECB in the wake of the Covid-19 health and economic crisis. On 27 March 2020, the ECB issued a Recommendation '*on dividend distributions during the COVID-19 pandemic and repealing Recommendation (ECB/2020/1) (ECB/2020/19)*'. Pursuant to this non-binding legal act, the ECB recommends SIs that, at least until 1 October 2020, no dividends (of any form) should be paid out and no irrevocable commitment to pay out dividends should be undertaken for the financial years 2019 and 2020, and that SIs should refrain from share buy-backs aimed at remunerating shareholders. On the basis of the '*comply or explain principle*', credit institutions which are

Article 16.2 (j) SSMR grants to the ECB the power to impose additional or more frequent reporting requirements, including reporting on capital and liquidity positions, while Article 16.2 (k) provides the ECB with the power to impose specific liquidity requirements, including restrictions on maturity mismatches between assets and liabilities.

Article 16.2 (l) SSMR vests the ECB with the power to require additional disclosures under Pillar 3. When adopting this supervisory measure, the ECB aims at strengthening market discipline and enabling investors, depositors and other third counterparties of the SI to react on the market by taking into account such additional information.

The final microprudential supervisory measure provided to the ECB under Article 16.2 SSMR is not listed in Article 104.1 CRD IV. According to Article 16.2 (m) SSMR, the ECB is empowered to remove at any time members from the management body of credit institutions who do not fulfil the fit & proper requirements set out under Article 91 CRD IV and the implementing national laws.

3.3. The application of national laws by the ECB

As discussed so far, the SSM is characterised by a number of peculiarities. On the one hand, it is an example of European direct administration and its establishment aimed at bringing about a coherent and harmonised regulatory framework, based on the CRD package, for banks established across multiple different sovereign states. On the other hand, one of the most striking features of the SSM is the ECB's newly acquired competence to apply the national legislation transposing EU directives (such as the CRD IV or the BRRD) or making use of ONDs provided to national legislators by EU law[578]. The fact that an EU institution can apply national substantive rules transposing EU Directives[579] has been described as '*a model of enforcement that is unseen in European law*'[580]. While this statement is certainly euphemistic as this is not unprecedented in Union law generally – the CJEU has been applying national law for decades in the context of Article 272 TFEU[581] – the application

unable to comply with the ECB Recommendation, should immediately explain the underlying reasons to their JST (Point I and II of the Recommendation). The Recommendation is also addressed to NCAs with regard to LSIs, as the ECB expects NCAs to apply the Recommendation to these entities and groups as deemed appropriate, as well as to NDAs. This temporary ban on the payment of dividends was reinforced by the EBA, which in its statement dated 12 March 2020 '*EBA statement on actions to mitigate the impact of COVID-19 on the EU banking sector*' urged banks '*to follow prudent dividend and other distribution policies, including variable remuneration*'. On 15 December 2020, the ECB repealed its March 2020 Recommendation and published a revised Recommendation '*on dividend distributions during the COVID-19 pandemic and repealing Recommendation ECB/2020/35 (ECB/2020/62)*'. Pursuant to this second Recommendation, the ECB recommended that banks exercise extreme prudence on dividends and share buy-backs and asked to consider not distributing any cash dividends or conducting share buy-backs, or to limit such distributions, until 30 September 2021. In particular, the ECB expects dividends and share buy-backs to remain below 15% of the cumulated profit for 2019-20 and not higher than 20 bp of the CET1 ratio, whichever is lower. Banks that intend to pay dividends or buy back shares need to be profitable and have robust capital trajectories, and they are expected to contact their JST to discuss whether the level of intended distribution is prudent. On the restrictions on shareholder's distribution in the context of the Covid-19 crisis, see Sciarrone Alibrandi and Frigeni (2020). On the monetary policy and banking supervisory measures adopted by the ECB following the outbreak of the Covid-19 crisis, see Gortsos (2020).

[578] Article 4.3 SSMR.

[579] When exactly it can be determined that national law transposes a EU Directive, and what would be the consequences for the ECB supervisory power under Article 4.3 SSMR and the single rulebook in case Member States were to transpose incorrectly, or not at all, provisions embedded into EU Directives, is a particularly complex legal question that lays beyond the scope of this work. For a discussion of these issues, see Bassani (2019); Kornezov (2016).

[580] See Allegrazza and Voordeckers (2015).

[581] According to this provision, Union courts have jurisdiction to give judgment pursuant to any arbitration clause contained in a contract concluded by or on behalf of the Union, whether that contract be governed by public or private

of national substantive laws by the ECB to carry out its newly-centralised supervisory tasks under the SSM raises a large number of interesting legal issues[582].

First and foremost, at present there are three main sources of national regulatory divergence affecting the functioning of the SSM: i) the 'minimum harmonisation' approach of EU Directives; ii) the differential exercise by the Member States of ONDs that are explicitly included in EU legislation; and iii) differential national legislation that has not been subject to EU harmonisation[583]. Starting from the first point, EU directives (such as the CRD IV) are generally minimum harmonising. EU Member States subscribe to a set of minimum standards in exchange for their firms gaining access to the markets of other jurisdictions. But Member States remain free to impose stricter standards if they choose to do so. The CRD IV, while it is mostly minimum harmonising, it covers many key prudential rules, such as access to the activity of credit institutions and the withdrawal of the license, the fit & proper assessments of banks' managers, the SREP, sanctioning powers and more. Another relevant example is the BRRD, which, *inter alia*, confers on banking supervisors a set of tools aimed at handling crisis situations at an early stage, i.e. early intervention measures[584]. While all of the above supervisory and resolution tools and powers are subject to national transposition and possible 'gold-plating' by EU Member States, the ECB, as single supervisor, will be called to understand, construe and apply national law concepts across 21 different jurisdictions. Additionally, when applying national laws, the ECB should take into account long-standing administrative traditions and local court precedents interpreting gold-plated provisions[585]. Difficulties may also arise from the interpretation of domestic prudential rules in multiple European languages embedded into national frameworks with their own specificities. This explains why NCAs will continue to play a significant role within the SSM and the ECB will undoubtedly need to make use of their local knowledge and supervisory expertise.

Turning to the second source of legal complexity – ONDs granted to EU Member States[586] – such measures can discourage further integration of the European banking sector. For example, subject to certain conditions, the CRR provides for waivers from the application of liquidity requirements on an individual basis. This should enable cross-border groups to manage their liquidity more efficiently, on a group-wide basis. But several Member States currently exercise an option not to exempt

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law. Union courts resolve such disputes on the basis of the substantive rules of the national law applicable to the contract – see, for example, CJEU, Case 426/85 (*Commission v Zoubek*), 18 December 1986, ECLI:EU:C:1986:501, para. 10; General Court, Case T-59/11 (*Isotis v Commission*), 16 July 2014, ECLI:EU:T:2014:679, para. 73; and General Court, Case T-155/14 (*ANKO v Commission*), 27 April 2016, ECLI:EU:T:2016:245, para. 39.

[582] On the topic of the ECB's application of national laws under Article 4.3 SSMR, see, among others, Bassani (2019); Witte

[583] In these terms, see de Guindos (2019).

[584] See Chapter 3, Paragraph 4.2.

[585] As discussed under Chapter 2, Paragraph 3.1.2., a major prudential area where the ECB has to apply inconsistent national provisions transposing Directives are the fit & proper assessments of members of a bank's management body. The result is that the ECB could be required in one jurisdiction to approve governance arrangements and suitability assessments of managers who would not be deemed suitable in other jurisdictions. Similarly, experience gained in the first five years of the SSM shows that differences in the crisis management toolkit (i.e. availability of early intervention measures) can hinder the prompt and effective tackling of crises.

[586] In an apparently incoherent fashion in respect of the goal to establish a fully harmonised European single rulebook for banking services, the CRD V package augmented the number of ONDs previously set out under the CRD IV package. The CRR II and the CRD V embed altogether around 200 ONDs, out of which around 150 ONDs are of microprudential nature and whose exercise is demanded to NCAs. For an analysis of the taxonomy of ONDs according to the SSMR and the ECB exercise of ONDs available in Union law, see Bassani (2019), p. 135 ff.

intragroup exposures from large exposure restrictions, thereby limiting banks' freedom to move liquidity between different group entities. This disincentivises banks from applying for liquidity waivers and ultimately limits the benefits of operating in more than one Member State. These Member State ONDs point to a larger issue with the single rulebook – namely, that it is more restrictive for banking groups operating across borders in the EU than it is for groups operating within a single Member State. For example, where an institution and parent company are located in the same Member State, the obligation to meet prudential requirements on an individual basis can be waived under specific conditions. This permission allows the group to meet requirements on a consolidated basis only, which can facilitate an efficient use of resources within the group. By contrast, this permission is not available where the individual institution is established in a different Member State from its parent[587]. This hampers cross-border banking and the creation of a banking sector truly European[588].

Finally, there are those areas of national law that have not yet been subject to EU harmonisation. As previously discussed[589], in the area of macroprudential policy, a substantial part of the toolbox is limited to national measures, which – in the absence of EU-level harmonisation – may result in inconsistent application of those instruments by the ECB and NDAs. Also, the interactions of national measures with other, more harmonised instruments may vary from one country to another, making it difficult for policy-makers to identify overlaps, assess interactions and calibrate policy measures in a coherent manner across jurisdictions. This calls for the extension of a more harmonised macroprudential toolkit at the EU level[590].

All the above-mentioned prudential areas represent significant challenges for the ECB as single supervisor to ensure the implementation of a single rulebook to banking services under a pan-European perspective and the coherent application of Article 4.3 SSMR. Accordingly, if the EU as a whole is to exploit in full the benefits of a fully integrated European banking market, further steps to reduce fragmentation in the prudential rulebook, and to harmonise related areas of national legislation, must remain a priority for EU authorities and regulators.

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[587] See de Guindos (2019).

[588] See Chapter 4, Paragraph II.

[589] See Chapter 2, Paragraph 2.3.1.

[590] A further example of national legislation that has not yet been subject to EU harmonization, even though it lies outside the supervisory field and therefore the remit of the ECB-SSM, is insolvency law, which is directly relevant for the resolution or liquidation of banks. The lack of harmonisation of insolvency law matters because bank failures are handled through insolvency – unless it is deemed in the public interest for the bank to be resolved by the SRB. Since national insolvency laws are very diverse, this can create significant uncertainty for creditors in the event of a failure.

IV. The Decision-Making Structure of the SSM

4.1. The establishment of the Supervisory Board

As a rule, decisions related to the performance of the ECB's supervisory tasks are adopted by the Governing Council (**GovC**)[591] under the non-objection procedure. Under this procedure, complete draft decisions are approved by the Supervisory Board (**SB**) and subsequently submitted to the GovC for final adoption. The complete draft decisions are deemed adopted if the GovC does not object within a maximum period of ten working days. The non-objection procedure is not only applied for individual supervisory decisions but is also used for ECB legal acts concerning the performance of supervisory tasks, policy documents or other forms of communication committing the ECB externally in the exercise of its supervisory tasks. The non-objection procedure is, however, not the only decision-making procedure in the ECB. Other decision-making procedures may apply and the delegation of decision-making powers for certain types of supervisory decisions has been put in place, e.g. for certain decisions on the classification of financial instruments as banks' regulatory capital[592].

The non-objection procedure is established under Article 25 SSMR giving due weight to the role of the SB as the internal body of the ECB, which is responsible for the planning and execution of supervisory tasks, including the approval of complete draft decisions. Under this procedure, the GovC cannot change complete draft decisions but can only approve or object to them within ten days from submission by the SB[593]. As mentioned earlier, in order to ensure full separation between the monetary and supervisory function, the SSMR provides for the establishment of the SB as a new body in charge of preparatory tasks with regard to legal acts and supervisory decisions relating to the performance of banking prudential supervision by the ECB. However, as the SB is not entrusted with final decision-making powers, it is not an ECB decision-making body[594]. Rather, the SB is conceived, within the SSM, as a 'decision preparing body' with the exclusive right to initiate the procedure for approval of supervisory measures. Accordingly, the SB is responsible for the planning and execution of the ECB's supervisory tasks as set out in the SSMR. The SB approval is required for all draft supervisory decisions with legally binding effect, prior to their submission to the GovC for final adoption under the non-objection procedure. Therefore, the decision preparing and making process in the SSM is characterised by a three-tier structure, that is i) the JSTs, which are the predominant

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[591] According to Article 129 TFEU and the statute of the ESCB, The GovC is the main decision-making body of the ECB. It consists of the six members of the EB, in addition to the governors of the national central banks of the 19-euro area countries. In particular, pursuant to Articles 3 and 10 of the statute, the main responsibilities of the GovC are: i) adopting the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the ECB and the Eurosystem, ii) formulating monetary policy for the euro area, including decisions relating to monetary objectives, key interest rates, the supply of reserves in the Eurosystem, and the establishment of guidelines for the implementation of those decisions, and iii) in the context of the SSM, adopting decisions relating to ECB draft legal acts that establish the general supervisory framework, and adopting the complete draft supervisory decisions proposed by the SB under the non-objection procedure.

[592] For a discussion of the decision-making process that applies to delegated supervisory decisions, see Chapter II, Paragraph 4.2.

[593] Article 26.8 SSMR.

[594] In its first proposal to establish the SSM, the EC envisaged the SB potentially as a decision-making body. However, in light of Article 129 TFEU and the CJEU's *Meroni* doctrine, according to which final decisions that externally commit the ECB can only be adopted by the decision-making bodies provided under the Treaties, the SB was established but ultimately could not be a final decision maker. For a critical analysis of this position, not shared by the Author, see Lackhoff (2017), p. 60 ff.

originators of draft decisions addressed to supervised entities[595], ii) the SB, responsible for the final SSM-internal approval of the content of individual supervisory decisions and any other banking supervision-related legal act, and iii) the GovC, responsible for approving, as ultimate decision-making body in the exercise of ECB's tasks, SB supervisory proposals and committing the ECB externally[596]. On all three levels, the NCAs are involved through national members in the JSTs, the members from the NCAs in the SB and the members of the NCBs in the GovC.

The SB is composed of the Chair, Vice-Chair, four ECB representatives, one representative of each NCA and one representative of each NCB (if the NCA is not a central bank)[597]. However, for the purposes of voting, the representatives of the NCA and the NCB of any pMSs are considered as one member[598]. The Chair and the Vice-Chair are appointed upon a proposal of the ECB, which shall be made after hearing the SB[599]. The proposal needs to be approved by the EP and is then adopted (or rejected) by an implementing decision of the Council[600]. While the Chair shall be chosen on the basis of an open selection procedure[601], the Vice-Chair shall be chosen from among the members of the EB. The term of office of the Chair is five years and not renewable, while the term of the Vice-Chair shall correspond to the term as EB member, which is eight years maximum and not renewable[602]. As much as the Chair and Vice-Chair, also the four ECB representatives are appointed by the GovC[603]. The appointment shall respect the principles of gender balance, experience and

[595] The SSM Secretariat Division within DG/SGO assists all SSM business areas in preparing documentation for the SB (including JSTs as regards the drafting of individual supervisory decisions) and advises on the SSM decision-making process. In this way, the SSM Secretariat Division ensures efficient decision-making, guaranteeing the institutional quality of the decision-making process. In addition, it provides support to the SB's activities, including by preparing and following-up on meetings and written procedures for the approval of banking supervision-related legal acts. Last, the SSM Secretariat Division liaises with the Secretariat of the GovC on all decision-making processes pertaining to the ECB's supervisory tasks and supports the preparation of the GovC meetings on supervisory matters.

[596] According to Article 25.5 SSMR, if the GovC objects to a decision submitted under the non-objection procedure, an NCA which is concerned by the decision and has different views may submit a request to the SB for mediation in order to resolve such differences, with a view to ensuring separation between monetary policy and supervisory tasks. The objection will be dealt with by the Mediation Panel (**MP**), which includes one member per pMS, chosen from among the members of the GovC and SB, and decides by simple majority, with each member having one vote. Due to the fact that this procedure is activated by the NCA(s) concerned, while the final decision is taken by the ECB's decision-making bodies following the opinion expressed by the MP members, it has been argued that the procedure before the MP may be qualified as a composite administrative procedure. See D'Ambrosio and Eckens (2020), p. 20. During the first six years of operation of the SSM, no MP was carried out.

[597] In most Eurozone countries, the central bank is officially recognised by national law as NCA (such as in Italy or Spain). However, in some pMSs this is not the case, such as in Germany (where the supervision of the banking sector in entrusted to the BaFin), Austria (where prudential banking supervision is carried out by the *Finanzmarktaufsicht*, or Financial Market Authority), and France (where the national authority empowered to supervise banks is the *Autorité de contrôle prudentiel et de resolution*, or French Prudential Supervision and Resolution Authority). For an overview table of the institutional banking supervisory frameworks across the SSM, see Gortsos (2019), p. 204.

[598] As such, in the case of Germany, for instance, the representatives from the Bafin and the *Deutsche Bundesbank* will share one vote only within the SB.

[599] Recital 65 SSMR.

[600] Article 26.3 SSMR. The appointment of the Chair and Vice-Chair shall respect the principles of gender balance, experience and qualification.

[601] The GovC (after hearing the SB) shall decide on a candidate among individuals of recognized standing and experience in banking and financial matters who are not members of the GovC. On the selection process the EP and the Council shall be kept duly informed. Since January 2019, the position of SB Chair is held by Andrea Enria (former Chairperson of the EBA), who substituted the first ever SSM Chair Danièle Nouy (former Secretary General of the *Autorité de contrôle prudentiel et de resolution*), who was on duty from 1 January 2014 to 31 December 2018.

[602] Article 11.2 of the ESCB statute.

[603] Article 26.5 SSMR.

qualification[604]. The four ECB representatives shall be appointed to the SB from among persons of recognised standing and experience in banking and financial matters. They shall perform their duties on a full-time basis and they shall not be engaged in any occupation, whether gainful or not, unless authorised by the GovC[605]. In particular, ECB representatives shall not perform duties for any NCA. The Chair and the four ECB representative may be removed from office before the end of the term only if they no longer fulfil the conditions required for the performance of their duties, or if they are guilty of serious misconduct. With regard to the Vice-Chair, she or he may be removed from being a member of the EB (and, hence, of the SB) upon decision of the CJEU according to the ESCB statute rules[606].

The SB adopts decisions in meetings or written procedures. Voting may take place in written procedure unless three members of the SB having a voting right object[607]. The SB meets regularly, on average every two weeks, and meeting shall normally be held in Frankfurt am Main at ECB premises[608]. In principle, decisions are adopted by simple majority. In case of a split vote, the Chair has the casting vote[609]. The SB quorum to take decisions is two-thirds of its members having a voting right (in case of a written procedure a quorum is not required as the absence of an explicit vote is deemed as approval)[610]. A qualified majority is required for decisions on the adoptions of regulations (and other binding acts of general application)[611], such as the FR. The qualified majority requires a double majority composed by 55% of the SB members and at least 65% of the total population represented by SB members[612]. The ECB members of the SB have a vote weight equal to the median weight of the NCAs representatives as calculated in accordance with the method laid down by the ECB Rules of Procedures[613]. The votes of the Chair and Vice-Chair have a zero weight and count only for determining whether the required majority of SB members is met[614].

Last, a Steering Committee supports the activities of the SB and prepares the Board's meetings. It is composed of a smaller group of SB members[615] and has no decision-making powers.

4.2. Supervisory decisions

Individual administrative decisions are the most common legal act used for the exercise of public policy powers by public authorities[616] and are adopted in compliance with procedural administrative

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604 Article 26.2 SSMR. To comply with this provision, the appointment process of the four ECB representatives is specified in Decision of the European Central Bank of 6 February 2014 on the appointment of representatives of the European Central Bank to the Supervisory Board (ECB/2014/4) (2014/427/EU).
605 See Lackhoff (2017), p. 64.
606 See Article 11.6 ESCB statute.
607 Article 6.7 SB Rules of Procedure.
608 The current premises of the ECB-SSM are located at the Eurotower in *Kaiserstraße* 29, 60311 (the previous monetary policy headquarters), while the monetary policy function is now carried out at the new ECB building in *Sonnemannstraße* 20, 60314.
609 Article 26.6 SSMR and Article 6.5 SB Rules of Procedure.
610 Article 6.7 SB Rules of Procedure.
611 Article 26.7 SSMR.
612 Article 13 c (ii) ECB Rules of Procedure. A blocking majority must include at least the minimum number of SB members representing 35% of the total population plus one member.
613 Article 13 c (iv) ECB Rules of Procedure.
614 Article 26.7 (2) SSMR.
615 According to Article 11.1 SB Rules of Procedure, the current number is eight.
616 See Lo Schiavo (2017), p. 96.

requirements. Within the SSM framework, ECB supervisory procedure means any ECB activity directed towards preparing the issue of an ECB supervisory decision, including common procedures and the imposition of administrative pecuniary penalties[617]. In turn, a ECB supervisory decision is defined as a legal act adopted by the ECB in the exercise of the tasks and powers conferred on it by the SSMR and is usually addressed to a supervised entity[618]. In substance, the ECB, through supervisory decisions, which are individual administrative legal acts issued by the EU public administration, exercises the supervisory powers granted to it by the CRD package as a result of the European implementation of the Basel Accords[619]. Supervisory decisions grant rights and/or imposes obligations modifying the situation for the supervised entity that is the addressee of the decision[620]. The decision may include ancillary provisions such as time limits, conditions, obligations or non-binding recommendations[621]. Unless adopted by means of delegation[622], a decision is approved in draft form by the SB and subsequently submitted to the GovC for adoption under the non-objection procedure. The ECB final supervisory decision has a legally binding effect on the addressee.

If the decision adversely affects the addressee, the final ECB supervisory decision is adopted after the addressee's hearing period has expired, taking due account of the points raised by the parties. The right to be heard is an essential procedural right provided by the SSMR[623] as the ECB shall base its supervisory decisions only on objections on which the parties concerned have been able to comment[624]. Consequently, if the rights of the addressee of the supervisory decision would be adversely affected by the decision itself, the ECB has to hear the addressee prior to adopting the decision (ex-ante hearing)[625]. This is in line with Article 41.2 of the Charter of Fundamental Rights of the European Union (the '**Charter**')[626] and the CJEU case-law[627]. Article 41.2 Charter stipulates that every person has the right to be heard before any individual measure which would affect him or

[617] Article 2 No (24) FR.
[618] Article 2 No (26) FR.
[619] Operational acts are excluded from the scope of formal decision-making processes as they do not have a required legal form and comprise non-binding and non-enforceable supervisory expectations, statements and other acts, usually communicated to supervised entities by the respective JST.
[620] Article 288 TFEU stipulates that EU Institutions, in order to exercise the Union's competences in compliance with the principle of conferral, shall adopt regulations, directives, decisions, recommendations and opinions. With regard to decisions specifically, Article 288 TFEU reads: '*A decision shall be binding in its entirety. A decision which specifies those to whom it is addressed shall be binding only on them*'. As regards the ECB decision-making powers, EU primary law establishes that the ECB can take decisions under Article 132.1, second indent, TFEU.
[621] For a discussion on the admissibility of ancillary provisions, see Chapter 2, Paragraph 4.1.1.
[622] See Chapter 2, Paragraph 4.2.
[623] Article 22.1 (1) SSMR.
[624] Article 22.1 (2) SSMR.
[625] Article 31.1 FR.
[626] The Charter brings together the most important personal freedoms and rights enjoyed by citizens of the EU into one legally binding document. The Charter was declared in 2000, and came into force in December 2009 along with the revised Lisbon version of the TEU and TFEU. The purpose of the Charter is to promote human rights within the territory of the EU. Many of the rights that are contained in the Charter were previously set out in i) the EU Treaties, ii) the European Convention on Human Rights (**ECHR**), iii) the case law of the CJEU, and iv) national constitutions. The Charter has the same legal power as an EU Treaty. This means that it is superior to the domestic laws of EU Member States. The Charter is consistent with the ECHR, and when the Charter contains rights that stem from the ECHR, their meaning and scope are the same.
[627] For an analysis of the CJEU case-law on the right to be heard, with a particular focus on composite procedures in the four policy areas of the remission of import duties, the European Social Fund, individual sanctions and state aid, see D'Ambrosio and Eckens (2020), p. 11 ff.

her adversely is taken[628]. Consequently, the right to be heard should at least be granted to every person – be it the addressee of a supervisory decision or not – that could contest the supervisory decision in court because of it being directly and individually concerned[629]. The right to be heard shall provide to the person that is to be heard the opportunity to comment on the relevant facts, objections and legal grounds of the decision. Facts mean all the relevant factual elements on which the decision is based. Objections are violations of legal requirements of which the addressee is accused and legal obstacles hindering the acceptance of an application. Legal grounds are the main legal arguments bearing the decision[630]. To this end, the ECB provides the draft supervisory decision to the person that has the right to be heard. It does so after the SB has adopted the draft decision but prior to providing this draft decision to the GovC[631]. Based on comments received, the ECB-SSM internal DG may decide to amend the draft supervisory decision. If it decides to do so, it will provide the SB with the revised version of the decision for its (second) clearance. Should the SB approve also the second version of the supervisory decision, the latter will then be submitted to the GovC for final approval. The usual time frame for providing comments under the hearing period is two weeks following receipt by the concerned person of the ECB statement setting out the facts, objections and legal grounds on which the ECB intends to base the supervisory decision[632]. In case of common proceedings (authorisation, withdrawal of the authorisation and approval to the acquisition of qualifying holdings) an obligatory shortening of the hearing period to three working days shall apply[633]. Under exceptional circumstances, an ex-ante hearing is not required if an urgent decision appears necessary in order to prevent significant damage to the financial system[634]. In these cases, an ex-post hearing shall be carried out.

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[628] Additionally, Article 41.2 Charter stipulates the right of every EU citizen to i) have access to his or her file, while respecting the legitimate interests of confidentiality and of professional and business secrecy, and ii) the obligation of the administration to give reasons for its decisions. With specific reference to the SSM, the right of access to files is set out under Article 22.2 SSMR and 32 FR, which determine that the parties to an ECB supervisory procedure, i.e. the concerned persons that would be able to contest the relevant ECB supervisory decision before the CJEU, have the right to access the file. As regards the duty to motivate its decisions, Article 33 FR requires that ECB supervisory decisions must be accompanied by a motivation stating the material facts and legal reasons. For an analysis of the Charter requirements on the operation of the SSM, see Álvarez et al. (2015). For a discussion of the right of access to files and motivation of supervisory decision by the ECB-SSM, see Lackhoff (2017), p. 116 ff.

[629] However, cases in which a party different from the addressee of the ECB supervisory decision is directly and individually concerned may not occur too often. In this regard, the CJEU, overruling the prior judgment delivered on the subject-matter by the General Court, has recently clarified that the shareholders of a supervised entity whose authorisation is withdrawn by the ECB are not directly (nor individually, in our view) concerned by the ECB supervisory decision. Therefore, the shareholders of a bank cannot challenge the ECB withdrawal decision in court (nor are they, as a consequence, entitled to the right to be heard or the right of access to file in the context of the ECB supervisory procedure that leads to the issue of the withdrawal decision). Indeed, the CJEU affirmed the principle that, even if due to the withdrawal of the authorisation, a given bank is no longer in the position to continue its activity as a credit institution and, consequently, its ability to distribute dividends to its shareholders is questionable, the negative effect of that withdrawal is economic in nature. The right of the shareholders to receive dividends, just like their right to participate in the management of that bank, if necessary by changing its object, is in no way affected by the supervisor's decision to withdraw the license. See CJEU, Joined Cases C-663/17 P, C-665/17 P and C-669/17 P (*Trasta v. ECB*), 5 November 2019, ECLI:EU:C:2019:923, para. 102-119.

[630] See Lackhoff (2017), p. 115.

[631] Article 31.1 FR.

[632] The hearing period may be extended, or shortened in particular circumstances to three working days. See Article 31.3 FR.

[633] Article 31.3 FR. Such provision results from the fact that in these cases the NCAs prepare the proposal for a decision and the ECB has a limited time frame to decide after the proposal is made by the NCA.

[634] Article 31.4 FR.

With regard to the possibility of the ECB to revoke its supervisory decision (whether lawful or unlawful), the general principles of Union administrative law indicate that Union institutions should have the power, under certain circumstances, to revoke their previous administrative decisions[635]. In this regard, Union banking law empowers[636] or requires[637] NCAs to revoke a previous supervisory decision in specific circumstances, but no provision grants expressly to the ECB the power to revoke its supervisory decisions. However, it follows from a general principle of Union law that '*a body which has power to adopt a particular legal measure also has power to abrogate or amend it by adopting an* actus contrarius*, unless such power is expressly conferred upon another body*'[638]. The Union law's notion of revocation decision therefore comprises any act which removes the effects, retrospectively (*ex tunc*) or prospectively (*ex nunc*), in full or in part, of a previous unlawful or lawful decision adopted by the same body or another one. The grounds justifying a revocation of a ECB supervisory decision, apart from cases where the applicable law empowers or requires the ECB to revoke a decision, can be grouped in three categories: i) revocation based on the ECB original decision[639], ii) revocation based on the addressee's conduct[640], and iii) revocation based on external factors[641]. In these cases, revocation of a supervisory decision by the ECB can take the form of:

i. full revocation, such as in the case a supervised entity can no longer comply with the requirements for the IRB approach because, after permission to use that model, no exposures could be included in the scope of the model;
ii. partial revocation, such as in the case of a supervised entity that obtained permission to repurchase own funds up to a predetermined amount for market making purposes but it does not make use of the full predetermined amount;
iii. amendments, such as in the case of a supervised entity that obtained permission to repurchase own funds up to a predetermined amount for market making purposes and asks to increase the permitted amount;
iv. replacements, such as in the case of a supervised entity that obtained permission to reduce own funds during a pre-determined period of time and after that authorisation, but before expiration of that period, it requests the same authorisation for a different period of time.

[635] Whilst some Member States have established general rules governing the power of public administrations to revoke previous administrative decisions, Union law does not provide for a general provision on the revocation of decisions, but allows Union institutions in specific circumstances to revoke their administrative acts (such as the EC in the context of competition proceedings pursuant to Council Regulation (EEC) No 4064/89 of 21 December 1989 on the control of concentrations between undertakings).
[636] Article 18 CRD IV and Article 31.5 FR.
[637] Article 101.3 and 101.4 CRD IV and Article 294.3 CRR.
[638] See General Court, T-251/00 (*Lagardère SCA and Canal+ SA v. Commission*), 20 November 2002, ECLI:EU:T:2002:278, para. 129 (with regard to the revocation of a merger approval decision); General Court, T-25/04 (*González y Díez SA v. Commission*), ECLI:EU:T:2007:257, para. 97 (with regard to the revocation of a state aid decision). In the legal doctrine, see Hofmann et al. (2013), p. 632.
[639] Such as in the case of supervisory decisions i) vitiated by grounds that would allow their annulment under Article 263.4 TFEU, ii) affected by errors committed by ECB-SSM staff, or iii) vitiated by a ground that would determine their non-existence.
[640] Such as in the case of supervisory decisions i) obtained by fraud or based on incorrect or incomplete information, ii) whose addressee does not meet the obligations or limitations imposed therein, or iii) a certain ancillary provision (i.e. the condition precedent) of the original decision is not met.
[641] Such in the case there are i) changes of facts after the adoption of the decision, or ii) changes in the applicable law after the adoption of the supervisory decision.

4.2.1. The admissibility of ancillary provisions

While Articles 288 and 132 TFEU mention decisions as a type of legal act that the ECB may adopt to exercise its competences, no provision in EU primary law or under the SSM framework grants expressly to the ECB the power to attach ancillary provisions to its supervisory decisions. Ancillary provisions can be understood in opposition to regulatory requirements. The latter are intended to be requirements provided in the applicable regulation necessary in order to assess the criteria for the adoption of a legal act. Conversely, the former are provisions attached to individual decisions which specify further behaviours or actions to be implemented by the addressee of the decision. Therefore, ancillary provisions serve the purpose to distinguish an administrative decision directly or indirectly affected by supplementary provisions from an outright positive or negative administrative decision. In this sense, decisions with ancillary provisions attached can be considered more beneficial for the applicant than a purely negative supervisory decision. Approving, for instance, the appointment of a board member under a condition precedent (e.g. the appointed member undertakes to follow specified training to fulfil the experience criterion[642]) may be more likely proportional than rejecting it outright. At the same time, as Article 288 TFEU expressly states that a decision adopted by a EU Institution is binding '*in its entirety*', ancillary provisions are always legally binding and enforceable on the addressee of the decision[643]. Ancillary provisions must respect the principle of proportionality and, hence, must be appropriate for attaining the objective of the decision and not go beyond what is necessary to achieve it. They can be classified as i) conditions, ii) obligations, iii) temporary clauses, and iv) recommendations.

Conditions are ancillary provisions that suspend the legal effectiveness of a decision until a specified event has happened (a condition precedent) or bring the legal effectiveness to an end in certain specified circumstances (condition subsequent). This means that a condition is either suspensive or resolutive[644].

Obligations are ancillary provisions which are deemed to ensure the proper implementation of the decision and are added as add on. Obligations are not suspensory. This means that the fulfilment or non-fulfilment of the obligation does not have a direct effect on the taking effect of the decision. But in case of non-fulfilment, the EU Institution that adopted the decision may revoke the permission or enforce the obligation. Obligations need to be related to the decision at issue and to be proportionate[645].

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642 Article 91 CRD IV.

643 For a reconstruction of the ECB power to attach ancillary provisions to supervisory decisions, see Lo Schiavo (2017).

644 Conditions are not enforceable on a stand-alone basis, but affect the validity of the main decision. That means that the ECB cannot force the supervised entity to comply with the relevant condition. But if the condition is not met, the supervised entity cannot make (any more) use of the permission.

645 The main distinction between conditions and obligations is, therefore, the impact on the legal effectiveness of the decision. Conditions have an impact on the legal effectiveness of the decision: – if a precedent condition is not fulfilled, the decision is not legally effective; – if a subsequent condition is fulfilled, the decision ceases to be legally effective. Conversely, obligations do not affect the legal effectiveness of the decision but are intended as being ancillary provisions that shall be respected and implemented in the follow-up phase after the decision enters into force (but that do not affect the legal effectiveness of the decision itself). Another important difference pertains to the effects of the failure to meet a condition or to fulfil a condition. If the condition (precedent) is not met, the decision ceases to produce effects; if an obligation is not complied with, the addressee may be subject to sanctions or other measures. Hence, obligations can lead to the revocation of the original decision if not complied with or the adoption of separate enforcement or sanction measures. See Lo Schiavo (2017), p. 98.

Temporary clauses are time limit provisions that can be included in a decision and limit, exclude or extend its application *ratione temporis*. While a condition presupposes a state of affairs that has not yet happened, temporary clauses refer to something that has already happened or will happen with certainty in future.

Recommendations are provisions that are not binding on their addressees, but suggest a specific rule of conduct.

In EU law, ancillary provisions, and particularly conditions and obligations, are known. According to Article 8.2 of the EC Merger Regulation[646], the EC may attach to its decision declaring a concentration compatible with the common market conditions and obligations intended to ensure that the undertakings concerned comply with the commitments they have entered into vis-à-vis the EC with a view to rendering the concentration compatible with the common market. Furthermore, according to Article 9.4 of the State Aid Procedure Regulation[647], the EC may attach to a positive decision conditions subject to which aid may be considered compatible with the internal market and may lay down obligations to enable compliance with the decision to be monitored. Under the State Aid Procedure Regulation, these are defined as conditional decisions. Moreover, numerous pMSs laws provide for conditions and obligations in administrative decisions. Finally, the CJEU accepted that restrictions or requirements may be attached to the approval of a qualifying holding provided that it shall ensure that the requirements stipulated by law for approving the acquisition are fulfilled[648].

Against this backdrop, ECB decisions with ancillary provisions (and, particularly, conditions and obligations), in the absence of a provision to the contrary in primary or secondary EU law, should be considered legally feasible[649]. In principle, the inclusion of ancillary provisions into an ECB supervisory decision triggers the right to be heard, given that it has adverse effects on the addressee[650]. An example of an ECB supervisory decision embedding a condition precedent is the permission granted to a supervised entity to classify financial instruments as CET1 regulatory capital under the condition that the instruments are fully paid-in and that their purchase is not directly or indirectly funded by the supervised entity[651]. An example of an ECB supervisory decision embedding an obligation could be the permission to use the IRB model under the obligation that the supervised entity implements certain model policy changes in line with Commission Delegated Regulation (EU) No 529/2014[652] (for instance, with regard to changes in the fundamental methodology for estimating PDs and LGDs, including best estimate of expected loss, and conversion factors). An example of an

[646] Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the '**EC Merger Regulation**').
[647] Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union (the '**State Aid Procedure Regulation**').
[648] CJEU, Case C-18/14 (*CO Sociedad de Gestion y Participación and Others*), 25 June 2015, ECLI:EU:C:2015:419.
[649] This position is shared in academic literature by, among others, Lo Schiavo (2017); Lackhoff (2017).
[650] However, it can be argued that in case ancillary provisions have been accepted by the addressee (e.g. by including them in written in its application, or by way of an *ex ante* written commitment of an authorised person), or if the ancillary provisions only mirror legal requirements (i.e. if conditions/obligations result directly from the applicable law), the right to be heard may not be required.
[651] In such a case, since the instruments have not yet been issued by the supervised entity, the ECB is not in a position to assess whether the financial instruments meet the Basel/CRR conditions and are, among others, fully paid-up and whether their purchase is not directly or indirectly funded by the applicant. Therefore, the condition precedent applies.
[652] Commission Delegated Regulation (EU) No 529/2014 of 12 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach.

ECB supervisory decision embedding a temporary clause may be the permission to exempt the supervised entity's exposures to its parent undertaking from the application of the large exposure requirements[653] for a certain period of time.

The scope of conditions and obligations in ECB supervisory decisions excludes from its assessment purely negative decisions (i.e. outright rejections of supervisory authorisations, applications or requests) as well as enforcement sanctioning ECB decisions. In those cases, the content of the ECB decision does not provide for a positive supervisory assessment which may be subject to conditions and/or obligations, but rather the ECB rejects an application or a request, in the former case, or it imposes enforcement measures or penalties on the addressee, in the latter.

4.3. Delegation of decision-making powers

As discussed, the issue of whether the ECB's decision-making authority in supervisory matters, capable of producing legal effects vis-à-vis third parties, could also be delegated to the SB has been the subject of controversy from the very start of the preparatory work on the SSM. As proposed by the EC, the draft SSM Regulation foresaw the possibility of the delegation of decision-making powers by the GovC to the SB[654]. This delegation clause was, however, not endorsed in the final version of the SSMR as the Council Legal Service argued that the Treaties and Article 12.1 ESCB statute establish the GovC and the EB as the only decision-making bodies of the ECB[655]. Consequently, delegating the GovC's decision-making powers to ECB administrative structures other than the EB would be equivalent to a modification of the ECB's decision-making arrangements set by the Treaties, and to the infringement of the institutional balance provided therein.

Against this backdrop, early experience of the SSM's functioning confirmed that there was a stringent institutional need for the simplification of the ECB's complex decision-making process in supervisory matters by means of internal delegation, especially with respect to routine and executive supervisory decisions[656]. To address this need, and to improve the efficiency of the ECB's decision-making process, the GovC decided to set up an institutional framework for the delegation of decision-making authority in supervisory matters to ECB internal administrative structures other than the EB[657]. In particular, the GovC approved ECB Decision ECB/2016/40139 (the '**general framework**

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[653] Article 395.1 CRR.
[654] EC (Sep 2012), para. 4.5.2. '*Governance*'.
[655] See Council (2012).
[656] See Nouy (2017).
[657] Legal scholarship generally deems such ECB-internal delegation of decision-making powers in supervisory matters permissible. See, among others, D'Ambrosio and Eckens (2020); Gren (2018); Lackhoff (2017). In particular, Gren argues that, although the Council Legal Service is of the view that the only legally permissible delegation of powers within the ECB is from the GovC to the EB, the issue needs to be approached in a broader context, also taking into account i) the literal interpretation of Article 12.1 ESCB statute, ii) the relevant case law of the CJEU, and iii) and the principle of separation between the ECB's monetary and supervisory policy functions. First, the second paragraph of Article 12.1 ESCB statute should be interpreted as one of the options for delegation available for the GovC, and not as the only one. This interpretation is supported by the fact that had the drafters of the Treaty wished to limit the scope of the addressees of the GovC's delegated decision-making authority solely to the EB, they would have expressly indicated it. Second, the CJEU has expressly recognised that the powers conferred on an institution include '*the right to delegate, in compliance with the requirements of the Treaty, a certain number of powers which fall under those powers, subject to conditions to be determined by the institution*'. See CJEU, case C–301/02 P (*Carmine Salvatore Tralli v. ECB*), 26 May 2005, ECLI:EU:C:2005:306, para. 41 and 42. Consequently, delegation of the ECB's decision-making powers from the GovC to lower administrative structures is not legally prohibited provided it complies with the general conditions for legitimate delegation of powers as developed by the Union's case law. Third, t is disputable whether delegation of discretionary

decision')[658], in which it develops a dedicated framework allowing for the transfer of decision-making competence in supervisory matters to lower administrative levels, namely heads of ECB working units. Under this framework, ECB senior managers (who usually are the heads of ECB-SSM internal DGs[659]) adopt supervisory decisions, instead of the SB and GovC. The ultimate objective of the delegated decision-making procedures is to relieve ECB decision-making bodies and the SB from a large volume of routine decisions, allowing them to focus on more complex supervisory issues. The general framework decision recognises the internal allocation of competence between the GovC, as the supreme decision-making body, and the EB, which is responsible for the ECB's current business, the set-up of its internal structure and staff[660]. Thus, any delegation of decision-powers taking place under the general framework decision only becomes effective if the EB adopts a decision to nominate a head of an ECB working unit (usually, a Director General) to receive such a delegation from the GovC[661]. This can be regarded as an example of the EB's involvement in supervisory policy decision-making which does not interfere with the principle of separation[662]. Crucially, delegation decisions need to be proportionate and they shall set out in detail both the scope of the matter to be delegated and the conditions under which such powers may be exercised[663]. In addition, delegation decisions shall specify that such decisions are always exercised on behalf of, and under the responsibility of, the GovC[664].

The delegation of powers under the general framework decision should be clearly distinguished from the internal allocation of competence between the GovC and the SB set out under the SSMR. The SB maintains its competence for planning, execution and preparatory work in respect of the tasks conferred on the ECB by that Regulation. Similarly, the general framework decision does not affect the SB's competence to propose complete draft decisions to the GovC under the non-objection procedure. On the basis of the general framework decision, the GovC has decided to transfer its decision-making authority on certain supervisory decisions with respect to: i) amendments to the significance status of supervised entities[665], ii) the assessment of fit & proper requirements for the

decision-making authority on supervisory matters from the GovC to the EB under would be fully consistent with the principle of separation, given the pivotal role of the EB in the ECB's decision-making process on monetary policy issues. See Gren (2018), pp. 24-25. Similarly, Lackhoff notes that already under the *Meroni*'s doctrine, the CJEU made it clear that a delegation of powers from a EU Institution to an external body is in principle permissible. Not delegable powers are only tasks and powers which give the delegating authority a wide margin of discretion which may make possible the execution of actual political decisions and economic policy. In the context of the SSM, the Author affirms that the adoption of supervisory measures directed to achieve external effects in specific cases may be delegated from the GovC to the SB insofar it complies with the EU law general principles and the CJEU case-law, and even if no explicit legal basis is set out under the SSMR. See Lackhoff (2017), pp. 82-83.

[658] Decision (EU) 2017/933 of the ECB of 16 November 2016 on a general framework for delegating decision-making powers for legal instruments related to supervisory tasks (ECB/2016/40).

[659] See Chapter 2, Paragraph 1.1.1.

[660] See Article 11.6 of the ESCB statute, which establishes the EB's responsibility for the ECB's current business. In addition, Articles 10.1 and 10.2 of the Rules of Procedure of the ECB further specify this competence by establishing that all ECB work units fall under the managing direction of the EB. Furthermore, Article 13m.1 of the Rules of Procedure provides that the EB's competence in respect of the ECB's internal structure and the staff also extends to the ECB's supervisory function.

[661] Article 5 general framework decision.

[662] See Gren (2018), p. 26.

[663] Article 4 general framework decision.

[664] Article 6 general framework decision.

[665] Decision (EU) 2017/934 of the European Central Bank of 16 November 2016 on the delegation of decisions on the significance of supervised entities (ECB/2016/41).

persons responsible for the management of SIs[666], iii) the classification of capital instruments as own funds[667], iv) the adoption of certain supervisory powers granted under national law[668], and v) the adoption of decisions on passporting, acquisition of qualifying holdings and withdrawal of authorisations of credit institutions[669].

[666] Decision (EU) 2017/935 of the European Central Bank of 16 November 2016 on delegation of the power to adopt fit and proper decisions and the assessment of fit and proper requirements (ECB/2016/42).

[667] Decision (EU) 2018/546 of the European Central Bank of 15 March 2018 on delegation of the power to adopt own funds decisions (ECB/2018/10).

[668] Decision (EU) 2019/322 of the European Central Bank of 31 January 2019 on delegation of the power to adopt decisions regarding supervisory powers granted under national law (ECB/2019/4). For an in-depth discussion of the delegated decision-making process for own funds decisions, see Chapter 3, Paragraph 2.3.

[669] Decision (EU) 2019/1376 of the European Central Bank of 23 July 2019 on delegation of the power to adopt decisions on passporting, acquisition of qualifying holdings and withdrawal of authorisations of credit institutions (ECB/2019/23).

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LIST OF ABBREVIATIONS – CHAPTER THREE

AT1	Additional Tier 1
BCBS	Basel Committee on Banking Supervision
BRRD I	Banking Recovery and Resolution Directive No I (*2014/59/EU*)
BRRD II	Banking Recovery and Resolution Directive No II (*2019/879/EU*)
CEBS	Committee of European Banking Supervisors
CET1	Common Equity Tier 1
CFF	Credit Conversion Factor
CJEU	Court of Justice of the European Union
COREP	Common Reporting
CRD I	Capital Requirements Directive No I (*2006/48/EC*)
CRD II	Capital Requirements Directive No II (*2009/111/EC*)
CRD III	Capital Requirements Directive No III (*2010/76/EU*)
CRD IV	Capital Requirements Directive No IV (*2013/36/EU*)
CRD V	Capital Requirements Directive No V (*2019/878/EU*)
CRR I	Capital Requirements Regulation No I (*2013/575/EU*)
CRR II	Capital Requirements Regulation No II (*2019/876/EU*)
CVA	Credit Value Adjustment
DG(s)	Directorate General(s) (of the ECB)
DG/SIB	DG Systemic and International Banks
DG/SGO	DG SSM Governance and Operations
DG/SPL	DG Specialised Institutions and Less Significant Institutions
DG/UDI	DG Universal and Diversified Institutions
DGS	Deposit Guarantee Scheme
EAD	Exposure at Default
EBA	European Banking Authority
EBU	European Banking Union
EC	European Commission
ECB	European Central Bank
ECHR	European Convention on Human Rights
EIM(s)	Early Intervention Measure(s)
EP	European Parliament
EU	European Union
FINREP	Financial Reporting
FRTB	Fundamental Review of the Trading Book
FSB	Financial Stability Board

GFC	(2007-08) Global Financial Crisis
GHOS	Group of Governors and Heads of Supervision
GovC	Governing Council
G-SIB(s)	Global Systemically Important Bank(s)
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Internal Liquidity Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IIIU	Internal Independent Investigating Unit
IRB	Internal-Ratings Based
IRRBB	Interest Rate Risk in the Banking Book
JST	Joint Supervisory Team
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LSI(s)	Less Significant Institution(s)
MDA	Maximum Distributable Amount
MPE	Multiple Point of Entry
MREL	Minimum Requirement (for own funds and) Eligible Liabilities
NCA(s)	National Competent Authority - ies
NCWO	No Credit Worse-Off
NRA(s)	National Resolution Authority - ies
NSFR	Net Stable Funding Ratio
OCR	Overall Capital Requirement
OJ	Official Journal (of the European Union)
O-SIB(s)	Other Systemically Important Bank(s)
PD	Probability of Default
PLTA	Profit and Loss Transfer Agreement
PONV	Point of Non-Viability
PSI	Private Sector Involvement
RAS	Risk Assessment System
RTS	Regulatory Technical Standard
RWAs	Risk-Weighted Assets
SA	Standardised Approach
SB	Supervisory Board
SEP	Supervisory Examination Programme
SI(s)	Significant Institution(s)
SMEs	Small and Medium Enterprises

SPE	Single Point of Entry
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SRMR	Single Resolution Mechanism Regulation (*2014/806/EU*)
SSM	Single Supervisory Mechanism
SSMR	Single Supervisory Mechanism Regulation (*2013/1024/EU*)
T2	Tier 2
TLAC	Total Loss-Absorbing Capacity
TLOF	Total Liabilities and Own Funds
TREA	Total Risk Exposure Amount
TSCR	Total SREP Capital Requirement

CHAPTER THREE

THE PRUDENTIAL AND ENFORCEMENT POWERS CONFERRED TO EUROPEAN AUTHORITIES OVER THE CAPITAL OF CREDIT INSTITUTIONS

I. CRD Package: An Overview of the Framework and the European Additions to the International Standards

1.1. Introduction

In Chapter 1, we analysed the prudential standards embedded in the Basel Committee on Banking Supervision (**BCBS)** soft-law international framework and their application to large, internationally active banks. We discussed in particular prudential requirements relating to the quality and composition of the banks' capital base and the function that banking capital has in safeguarding financial stability and ensuring market discipline vis-à-vis investors and depositors. The aim of Chapter 1 was to shed light on how the BCBS framework flexibly evolved over the decades in response to different global sovereign or financial crises, with the primary goal to ensuring international financial stability and the soundness of financial institutions. Accordingly, we examined how virtually all countries over the world (and not only BCBS member jurisdictions) tend to implement the Basel framework as golden benchmark in banking supervisory and prudential matters, and what currently are the main challenges and trade-offs that developed jurisdictions as well as emerging and low-income economies face in the implementation of the BCBS standards.

In Chapter 2, we discussed the establishment of the Single Supervisory Mechanism (**SSM**), as first pillar of the ambitious European Banking Union (**EBU**) project, and we illustrated the reasons why we deem that the SSM constitutes a 'Copernican revolution' in European administrative and banking law, and in which way it created a multi-layered pan-European system of prudential supervision that significantly reshaped the operation of public supervisory administrations within the Eurozone (and the non-Eurozone Member States participating to the SSM). Under this perspective, we discussed the macro- and microprudential supervisory tasks and powers that have been centralised to the European Central Bank (**ECB**) to ensure compliance by Euro area credit institutions with the Basel prudential standards[670]. To this end, we also described the supervisory decision-making structures deputed to adopt regulatory acts and administrative individual decisions addressed to significant credit institutions (**SIs**) as well as, where applicable, less significant credit institutions (**LSIs**). Building-up on the arguments developed in Chapter 2, in Chapter 3 we will focus specifically on a sub-set of prudential tasks and powers entrusted to Banking Union authorities, i.e. the ECB within the SSM and the Single Resolution Board (**SRB**) within the Single Resolution Mechanism (**SRM**), namely

[670] Prudential requirements are a set of provisions with which banks must comply to obtain authorisation from competent authorities to provide their services. As a sub-set of prudential requirements, capital requirements aim to establish the level of adequate capital that credit institutions must hold to face the risks they undertake, and are expressed as a ratio between the institutions' capital base (equity and equity-like instruments) and their risk-weighted assets (**RWAs**). See Stamagna (2019). For a reconstruction, also in the historical perspective, of the current global capital adequacy framework for banks, see Chapter 1, Paragraph 1.2. ff.

prudential tasks and powers over the capital of Eurozone credit institutions[671]. In this context, we will analyse, among others, under what conditions SIs may receive permissions from the ECB, as prudential supervisor, to compute financial instruments as regulatory capital, reduce their own funds and use internal measurement approaches to calculate RWAs and minimum capital levels.

1.2. The CRD V package

As discussed under Chapter 2, the Basel III Accord was implemented in the European Union (**EU**) under two separate legislative streams over a time period of six years, i.e. the CRD IV package in 2013 and the CRD V package in 2019. The CRD IV package represented the third set of amendments to the original Capital Requirements Directive recast in 2006[672], following two earlier sets of revisions adopted in 2009 (the '**CRD II**')[673] and 2010 (the '**CRD III**')[674]. Among the other things, the CRD III implemented Basel 2.5 in Europe[675]. The implementation of Basel III by EU co-legislators (i.e. the European Parliament (**EP**) and the Council of the European Union (the '**Council**')) over such a broad time horizon, and the need to adapt these international standards to the specificities of 27 different banking systems, and more generally of the European economies, are clear indicators of the complexity that lies behind the policy trade-offs characterising the adoption of the Basel standards at the national level. In particular, EU authorities demonstrated to be sensitive to the application of Basel III as, unlike the US, they decided ultimately to apply the Basel framework to all EU banks and investment firms, regardless of their size, and not only to internationally active banks[676]. Moreover, unlike in the US where capital markets are well-developed, banks in the EU provide most of the credit to the real economy – hence the concern that higher capital requirements might reduce the flow of credit to the real economy[677].

[671] As the CRD package and the Banking Recovery and Resolution Directive (**BRRD**) apply to the entire EU, in principle the supervisory and resolution powers over the capital of credit institutions that will be discussed in this Chapter have been conferred to all EU competent authorities (and, therefore, also to the ECB and the SRB within the SSM and the SRM, respectively). While Chapter 3 will focus specifically on the ECB and SRB's capital adequacy public administrative powers within the Banking Union, it can be assumed that the same prudential and resolution tasks and powers are conferred to non-Eurozone competent authorities, unless expressly stated otherwise.

[672] Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (the '**CRD I**'), together with Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions (which will be turned into the CRR in 2013), implemented the Basel II Accord in the EU. All EU Member States transposed these Directives into national legislation by end-2006. The implementation of Basel II in the EU began on 1 January 2007, while the use of advanced IRB approaches for calculation of capital requirements for credit and operational risk, subject to prior supervisory approval, was enabled starting from 1 January 2008.

[673] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management

[674] Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies.

[675] On the rationale of Basel 2.5, see Chapter 1, Paragraph 1.5.

[676] The EU is the only jurisdiction worldwide codifying Basel III under a common framework that, in turn, must be partially implemented under the national laws of 27 countries, whose banking systems collectively represent about one-third of the world's banking assets. Other jurisdictions, such as the US, largely leave this responsibility to the discretion of national supervisory authorities. On the implementation of the Basel standards in the United States, see Dugan and Xi (2011).

[677] See Quaglia (2015), p. 15.

In contrast to previous EU reforms implementing the BCBS standards, the CRD IV package is composed of a directive (i.e. the CRD IV[678]) governing the access to banking activity, sound governance and risk management practices and fit & proper assessments, and a regulation (i.e. the CRR I[679]) establishing, for the first time, directly applicable rules as regards the calculation of the amount of capital banks must set aside, as well as requirements on disclosure, reporting and liquidity. As much as Basel III at the international level, the CRD IV package exponentially increased the level of complexity and technicality of the European prudential framework, as the CRR consists of 521 articles and 3 annexes, while the CRD IV is composed of 165 articles and 2 annexes, which altogether weight in at about 230,000 words. The implementation of Basel III in the EU through the CRD IV package began in 2013 and it was gradually phased-in until 2019. That same year, the CRD V package, complementing the prudential framework introduced by the CRD IV and CRR I, was approved by the EP and the Council[680]. As expected, the main features of the CRD IV package reflected the underlying objectives of the Basel III framework, which have been extensively discussed under Chapter 1. Accordingly, the CRR provides for inter alia a harmonised and more transparent definition of regulatory capital, establishing that it must be predominantly made up of common shares and retained earnings (‘**Common Equity Tier 1**’ or ‘**CET1**’), and sets minimum prudential ratios (Pillar 1 requirements) under the total risk exposure amount (**TREA**)[681] to address major risks inherent in activities carried out by credit institutions, such as credit, operational and settlement risk, as well as risks arising from the trading book business.

On the other hand, the CRD IV regulates the access of credit institutions to the banking market and sets out risk-based prudential requirements to ensure the sound and prudent supervision of banks. The CRD IV establishes rules on corporate governance and risk management[682], it lays down the tasks and powers of national competent authorities (**NCAs**) – including the ECB – with regard to the authorisation of banks and the withdrawal of the banking licence[683], as well as the appointment of banks’ managers[684], and the rules they must follow when carrying out the supervisory review and evaluation process (**SREP**) and impose qualitative or quantitative supervisory measures to cover for institution-specific risks (Pillar 2 capital or liquidity add-ons)[685]. Furthermore, the CRD IV transposes the Basel III macroprudential tools and capital buffers into EU law, among which the capital

[678] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.
[679] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.
[680] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (the ‘**CRR II**’), and Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (the ‘**CRD V**’). The consolidated legal texts of the CRR and the CRD IV (which are still in force as they have been – substantially, in some parts – amended by the CRR II and the CRD V, but not repealed) currently embed the prudential rules to be applied by SSM authorities as well as non-Eurozone supervisors.
[681] Article 92.3 CRR.
[682] See Chapter 2, Paragraph 3.1.2.
[683] See Chapter 2, Paragraph 2.1.1. and Paragraph 2.1.2., respectively.
[684] See Chapter 2, Paragraph 3.1.2.
[685] For an overview of the supervisory powers available to the ECB as banking supervisor, see Chapter 2, Paragraph 3.1.3. For an in-depth discussion of the ECB-SSM SREP, see Chapter 3, Paragraph III.

conservation buffer and the countercyclical buffer stand out as key components[686]. In addition to Basel III macroprudential buffers, the CRD IV provides for a systemic risk buffer meant to prevent and mitigate long-term non-cyclical systemic or macroprudential risks, and it implements the capital framework set out by the FSB and the BCBS for global systemically important banks (**G-SIBs**)[687]. Finally, the CRD IV envisages a capital layer for other systemically important banks (**O-SIBs**) as identified by national supervisors in line with the BCBS methodology[688]. Both CRR and CRD IV came into effect on 1 January 2014 and have been supplemented over the course of the years by EC's delegated regulations, as drafted by the European Banking Authority (**EBA**) in the form of technical and implementing standards[689].

Against this background, on 23 November 2016 the European Commission (**EC**) published the first legislative proposal comprising far-reaching amendments to the CRR[690] and the CRD IV[691]. Following extensive public consultations, the CRD V reform package was published in the Official Journal of the European Union (**OJ**) on 20 May 2019. While the CRD V had to be transposed by EU Member States by 28 December 2020[692], the CRR II provisions were gradually phased-in from 27 June 2019 to 28 June 2021[693]. In general terms, the CRD V package' amendments, with the intention to ensure full effectiveness of the Basel III framework at the regional level, contain three main groups of provisions, covering capital and liquidity requirements, aspects of proportionality and the EU resolution framework[694].

With regard to the first group of provisions, the CRR II and CRD V aimed at: i) reducing excessive leverage by introducing a binding 3% leverage ratio – together with the leverage ratio surcharge for G-SIBs set at 50% of the G-SIB's risk-based buffer[695] – and revising disclosure requirements for large banks in this respect[696], ii) addressing long-term funding risk by introducing the net stable

[686] For an analysis of the international macroprudential framework, see Chapter 1, Paragraph 3.1. The macroprudential powers and tools at disposal of the ECB and national authorities within the Banking Union are discussed under Chapter 2, Paragraph 2.3.

[687] See Chapter 1, Paragraph 3.1.

[688] See Chapter 2, Paragraph 2.3.1.

[689] Although not in scope of the CRD package, accountancy principles play an increasingly important role for prudential supervisors, particularly as International Financial Reporting Standards (**IFRS**) are used by credit institutions in their reporting activities and in the determination of the fair value of their liabilities (see, in particular, IFRS No 13). For an analysis of the interactions between prudential supervisory rules and accounting principles, see Kashyap (2015).

[690] Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012, COM/2016/0850 final - 2016/0360.

[691] Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, COM/2016/0854 final - 2016/0364.

[692] Article 2 CRD V.

[693] Article 3 CRR II.

[694] For an overview of the CRD V package, see Stamagna (2019).

[695] At the same time, Article 429a CRR II introduced the exemption (or preferential treatment) for certain categories of exposures from the leverage ratio requirement, such as i) exposures linked to public development banks and passing through promotional loans, ii) exposures linked to client clearing activity, iii) intra-institutional protection schemes and intragroup exposures, and iv) central bank reserves, subject to the approval of the supervisory authority.

[696] Under the CRD V package, the EBA has been tasked with adjusting the technical standards for reporting and disclosing the leverage ratio. A key focus will be on exposures particularly vulnerable to what is known as 'window dressing', which can be defined as banks changing their business activities when reporting and disclosure dates are coming closer in order

funding ratio (**NSFR**) framework[697], iii) addressing market risk by increasing the risk sensitivity of existing requirements in line with the Basel work on the 'fundamental review of the trading book' (**FRTB**)[698], iv) clarifying the cases in which additional capital requirements set by competent authorities under the SREP (Pillar 2 capital add-ons) may be imposed, and their ranking ('stacking order') in relation to minimum capital requirements and the combined buffer requirement[699], and v) excluding certain public development banks and credit unions from the scope of the CRD-CRR prudential framework[700].

With regard to the principle of proportionality, the second group of the CRD V package's provisions focuses on easing the compliance burden for smaller and non-complex banks without compromising their individual soundness and stability, particularly with regard to reporting and disclosure requirements[701], as well as improving banks' lending capacity to support economic growth (in particular for small and medium enterprises (**SMEs**)). Last, the third group of provisions aims at implementing the external and internal TLAC components into the EU legal order and increasing G-SIBs and large EU banks' loss absorption and recapitalisation capacity.

As all the above requirements are substantially in line with the Basel framework and have been already discussed under Chapter 1 and Chapter 2[702], Chapter 3 will focus on the application and enforcement of the BCBS and FSB's capital standards in the context of the Banking Union, as well as on certain 'European additions' introduced by EU regulators in the context of the adoption of the CRD V package, namely the intermediate parent undertaking requirement and the minimum requirement of own funds and eligible liabilities (**MREL**)[703], as addition to the Financial Stability Board (**FSB**) TLAC standard[704].

Finally, it is worth mentioning that, according to information publicly available, the EC has not communicated yet a timeline for the implementation of the Basel IV reform within the EU[705]. The EC's legislative proposals whereby Basel IV is to be transposed into EU law – something that,

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to report improved prudential metrics. It has therefore already been decided that large banks will in future have to calculate such exposures more frequently than at the three- month intervals currently stipulated. See Deutsche Bundesbank (2019).

697 Article 428b CRR II.

698 On the BCBS's FRTB reform, see Chapter 1, Paragraph IV. In line with the international framework, the CRR II provides for: i) clearer rules on the scope of application to prevent regulatory arbitrage (i.e. trying to pick the most favourable capital treatment between the trading book and the banking book), ii) requirements more proportionate, to reflect the risks to which banks are exposed more accurately, iii) the strengthening of the conditions to use internal-ratings based (**IRB**) models to enhance consistency and risk-weight comparability across banking systems. In particular, banks with small trading books (under EUR 50 million and less than 5% of the institution's total assets) are allowed to apply the treatment of banking book positions to their trading book. On the other hand, banks with medium-sized market activities (under EUR 300 million and less than 10% of the institution's total assets), may use the simplified standardised approach (**SA**). See Stamagna (2019).

699 See Chapter 3, Paragraph 3.3.

700 As discussed under Chapter 2, Paragraph 1.2., Article 1.1 CRD V is the newly-introduced provision by virtue of which the German promotional bank *Landeskreditbank Baden-Württemberg – Förderbank* managed to escape direct ECB supervision after unsuccessfully challenging before the Court of Justice of the European Union (**CJEU**) the ECB significance decision according to which it was classified as SI by the Euro area supervisor.

701 The newly-introduced category of 'small and non-complex institution' under Article 4 CRR II and the EU strategy as regards the application of the principle of proportionality in banking regulation are discussed under Chapter 3, Paragraph 1.2.2.

702 See Chapter 2, Paragraph 3.1.

703 The MREL capital buffer will be discussed under Chapter 3, Paragraph V.

704 See Chapter 1, Paragraph III.

705 For an overview of the Basel IV reform, see Chapter 1, Paragraph IV.

informally, has been defined already by policy commentators as ‘CRD VI package’, composed by the ‘CRR III’ and the ‘CRD VI’, respectively – were initially expected for July 2020. However, the EC stated on 28 April 2020 that it will use the additional time freed-up by the postponement to take the impact of the Covid-19 pandemic on the banks’ financial situation into account for its forthcoming proposal on the Basel IV package[706]. Considering that the starting implementation date of Basel IV has been postponed of one year to 2023, one may expect that in the course of 2021 relevant information and, possibly, legislative proposals concerning the CRD VI package will be made available to the public. However, the rating agency *Standard & Poor’s* already pointed in January 2020 to the risk of missing the deadlines of the Basel IV reforms, assuming strong resistance against those reforms from banks across Europe[707]. Other market participants, such as the Dutch bank *ING*, speculate whether a further delay in publishing the EC’s CRD VI package proposals may eventually result in a postponement of the reforms’ implementation date until 1 January 2024 instead of 1 January 2023[708].

1.2.1. The intermediate parent undertaking

As European addition to the Basel framework, the CRD V introduces a new requirement for third-country banking groups that have at least two subsidiaries established in the EU and whose assets within the EU exceed a threshold of EUR 40 billion (including branches). According to Article 21b CRD V, such third-country banking groups must set up an intermediate parent undertaking (**IPU**) in the EU for their EU subsidiaries[709]. This requirement means that all activities of the third-country banking group’s subsidiaries established in the EU must be supervised on a consolidated basis under the newly-established EU parent[710]. The IPU shall be established and authorised either as credit institution, or financial holding company or mixed financial holding[711].

The objective of the IPU requirements is to make it easier for NCAs – including the ECB – to supervise third-country banking groups in the EU and, if need be, to resolve their activities. If a single IPU would be in contrast with third country laws or would render resolvability more complex, the relevant NCA may allow structures with two intermediate EU parent undertakings[712]. The IPU requirement will become effective following a transitional period of three years from the date of application of the CRD V, i.e. 28 December 2020.

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[706] See Q&As from the EC on the coronavirus response, EC (Apr 2020).
[707] See *Standard & Poor’s* (2020).
[708] See Dias et al. (2021).
[709] On the IPU requirement see also Deutsche Bundesbank (2019).
[710] Although EU branches of the third-country banking group are included in the calculations on the size threshold, they are not required to join the IPU. See Article 21b.7 CRD V.
[711] By way of derogation, the IPU may also be established in the form of investment firm, if the group focuses mostly on such business activities and none of the two subsidiaries owned at EU level is a credit institution.
[712] For instance, if ring-fencing rules in the third country include a mandatory requirement for separation of activities and are therefore incompatible with the consolidation of all EU business activities under a single intermediate EU parent. See Article 21b.2 CRD V.

II. Quality and Composition of EU Credit Institutions' Regulatory Capital

2.1. Classification of financial instruments as CET1 capital

As discussed under Chapter 1, Basel III, with a view to remedying to the insufficient and low-quality level of capital that banking systems owned globally in the run-up to the 2007-08 global financial crisis (**GFC**), introduced enhanced capital requirements that strengthened the capital base of credit institutions under both a qualitative and quantitative perspective. Within the EU, such standards were implemented by the CRR[713]. With a view to ensuring the quality, transparency and loss-absorbing capacity of the capital base of banks, the CRR centralises to the ECB the power to classify financial instruments as components of the regulatory capital of SSM credit institutions. In line with Basel standards, the CRR framework establishes that the capital base of EU banks must be composed of Tier 1 'going concern' capital, as divided into the two sub-categories of CET1 and Additional Tier 1 (**AT1**) financial instruments, and Tier 2 (**T2**) 'gone concern' capital[714]. In particular, Article 92 CRR lays out that EU credit institutions shall at all times satisfy the following own funds requirements as a percentage to RWAs: i) a CET1 capital ratio of 4,5%, ii) a Tier 1 capital ratio of 6%, and iii) a total capital ratio of 8%. The minimum capital base required of CET1 instruments is, however, raised at all times to 7% as EU banks need also to meet the 2,5% CET1 capital conservation buffer under Article 129 CRD IV. Therefore, the total minimum capital ratio equals to 10,5%, out of which 8,5% must be Tier 1 equity or equity-like capital.

Against this backdrop, the CRR entrusts the ECB-SSM with supervisory powers relating to the classification of financial instruments as SIs' regulatory capital. The objective of EU regulators is to enable NCAs, through public administrative powers, to assess CET1, AT1 and T2 issuances with a view to ensuring the good quality of the regulatory capital and the consistency in the composition of the capital base of EU banks. In particular, Article 26.3 CRR entrusts the ECB with the power to approve the classification by SSM banks of capital instruments as CET1 instruments for regulatory purposes. The CRR rules on the financial instruments that can be classified as CET1 capital and their eligibility criteria are largely consistent with the BCBS regime[715]. In this sense, CET1 items of credit institutions shall consist of the following: i) ordinary shares (i.e. capital instruments that meet the conditions laid out under Article 28 CRR), ii) share premium accounts related to ordinary shares, iii) retained earnings, iv) accumulated other comprehensive income, v) other reserves, and vi) funds for general banking risk. In turn, Article 28 CRR details all the term and conditions that CET1 must meet to be classified for regulatory purposes. Eligible CET 1 instruments must be directly issued by the credit institution and paid up, and they must have not been funded directly or indirectly by the issuer. They have to be fully available to the institution, subordinated to all other claims, and perpetual. The payments to their holders must be at the full discretion of the institution. The instruments must ensure the highest degree of loss absorbency. Therefore, CET1 instruments rank below all other claims in the event of insolvency or liquidation of the bank, but the holders are entitled to a claim on the residual

[713] Articles 25 to 91 CRR. The CRR capital adequacy framework is complemented by the provisions of Commission Delegated Regulation (EU) No 241/2014 of 7 January 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for Own Funds requirements for institutions (the '**RTS on Own Funds**').
[714] See Chapter 1, Paragraph II.
[715] See Chapter 1, Paragraph 2.1.1.

assets of the institution in the event of liquidation. The instruments are not collateralised or subject to a guarantee or to an arrangement designed to enhance their seniority[716]. The prior permission to classify financial instruments as CET1 capital for regulatory purposes must be adopted by the ECB-SSM by means of a supervisory decision adopted through the non-objection procedure[717], unless delegated decision-making applies[718], and communicated to the relevant SI that submitted the application[719].

Against this backdrop, the CRR II introduces new requirements aimed at i) simplifying the approval process for the classification of CET1 instruments, ii) strengthening banks' capital adequacy by modifying the eligibility criteria so to integrate own funds and eligible liabilities[720], and iii) introducing a special regime for profit and loss transfer agreements (**PLTA**). With regard to the first CRR amendment, Article 26.3 CRR II introduces a prior notification mechanism (rather than approval) for banks that wish to classify financial instruments as CET1 capital under the conditions

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[716] To facilitate the ECB task to assess SIs' applications on the classification of financial instruments as CET1 capital, and also in light of the fact that EU Member States' national corporate laws are not harmonised and ordinary shares may incorporate significantly diverging legal features across SSM jurisdictions, Article 26.3, subparagraph 4, CRR mandates the EBA to maintain and publish a list of all forms of capital instruments in each EU Member State that qualify as CET1 instruments, based on relevant information collected from NCAs. The inclusion of a type of instrument in the EBA list implies that it meets the eligibility criteria set out in Article 28 CRR. Therefore, when deciding on an application to give permission for CET1 classification, the ECB shall take into account in its assessment the fact that the instruments are on the EBA's list of capital instruments in EU Member States qualifying as CET1. The EU-wide CET1 instruments list is published on the EBA website and regularly updated.

[717] See Chapter 2, Paragraph IV.

[718] See Chapter 2, Paragraph 4.2.

[719] The public administrative powers conferred to the ECB under Article 26.3 CRR have already induced the institution of legal proceedings before the CJEU. In Cases T-576/18, T-577/18 and T-578/18, actions for annulment were brought by credit institutions belonging to the *Crédit Agricole* group against three ECB contested supervisory decisions. As the ECB argued to have found that such banks had classified capital instruments as CET1 without obtaining prior supervisory authorisation in breach of Article 26.3 CRR, and found that the breaches had been committed negligently, it imposed on i) *Crédit Agricole SA* (applicant in Case T-576/18) a pecuniary penalty of EUR 4,300,000, representing 0.0015% of the annual turnover of the *Crédit Agricole* group, ii) *Crédit Agricole Corporate and Investment Bank* (applicant in Case T-577/18) a penalty of EUR 300,000, representing approximately 0.001% of the group's annual turnover, and iii) *CA Consumer Finance* (applicant in Case T-578/18) a penalty of EUR 200,000. The three applicants challenged the legality of the contested ECB decisions before the General Court both in so far as it was found in those decisions that there had been a regulatory breach by the applicants, and in so far as the supervisory decisions imposed on the applicants an administrative penalty. In its judgment dated 8 July 2020, the General Court found that the applicants have not demonstrated that the ECB's decisions were unlawful in so far as it was found in those decisions that there had been a regulatory breach by the applicants. In that regard, the Court pointed out that Article 26.3 CRR must be interpreted as requiring a credit institution to obtain the permission of the competent authorities before classifying its capital instruments as CET1 instruments. As such, within the SSM, SIs must seek prior supervisory approval by the ECB. However, the General Court partially annulled the contested ECB decisions on the basis that no adequate reasons were given for the pecuniary penalties imposed on the applicants. Specifically, the General Court highlighted that the ECB enjoys a wide discretion to determine the amount of the pecuniary penalty, which can be up to 10% of the total annual turnover of the group to which the company in question belongs. However, this discretion must be compensated with a sufficient statement of reasons, and the ECB should have provided details of the methodology applied in determining the amount of the penalties imposed. The General Court noted that the ECB merely put forward a number of considerations relating to the seriousness of the breach, its duration, the seriousness of the failure of which the applicant was accused as well as an assurance that one or more attenuating circumstances had been taken into account. Lastly, the General Court noted that, by not indicating in the decisions at issue the size of the credit institution that committed the breach in question, the ECB failed to mention a factor particularly relevant to the determination of the amount of the penalty and to review whether the penalties applied are effective, proportionate and dissuasive. See General Court, T-576/18, (*Crédit agricole v ECB*), 8 July 2020, ECLI:EU:T:2020:304; General Court, T-577/18, (*Crédit agricole Corporate and Investment Bank v ECB*), 8 July 2020, ECLI:EU:T:2020:305; General Court, T-578/18, (*CA Consumer Finance v European Central Bank*), 8 July 2020, ECLI:EU:T:2020:306.

[720] See Chapter 3, Paragraph IV.

that i) the instrument is substantially the same as previously issued instruments for which the bank already received permission to classify as CET1, and ii) the competent supervisory authority is notified sufficiently in advance[721]. Second, the CRR II, upholding a substance over form approach, introduces an anti-circumvention principle with a view to aligning the eligibility criteria for AT1 and T2 with eligible liabilities under the resolution framework[722]. According to this principle, the combined economic effects of the terms and conditions of an instrument and all arrangements related to that instrument must be assessed in conjunction with the main terms and conditions of the issuance, so that the overall substance of the instrument/transaction is captured. The eligibility of the instrument should not be assessed on an isolated basis, but as part of the wider transaction. The CRR II objective is to maintain the quality of capital and eligible debt with a view to enhancing their loss absorbing capacity, by fully aligning the eligibility criteria for these instruments. Last, the CRR II waives the prohibition for CET1 instruments to carry an obligation to make distributions when a PLTA is in place. As a general rule, CET1 instruments are prohibited to carry an obligation to make distributions. However, under certain conditions, such an obligation following from a profit and loss transfer agreement is allowed[723]. Where a SI has entered into a profit and loss transfer agreement, it shall notify the ECB without delay and provide the competent authority with a copy of the agreement. The new CRR II own funds requirements apply from 27 June 2019 onwards.

2.2. Classification of financial instruments as AT1 and T2 capital

Articles 52 and 63 CRR set out the eligibility criteria to be met by capital instruments to qualify as AT1 and T2 instruments, respectively. In line with the BCBS capital framework[724], eligible AT1 instruments are issued and paid up, and they must have not been funded directly or indirectly by the issuer and not purchased by the institutions or its subsidiaries[725]. They have to be fully available to the institution, subordinated to T2 instruments, and perpetual. They have no incentive to redeem. The payments of distribution/coupons must be at the full and sole discretion of the issuer. They are not cumulative. The instruments must have a loss absorbency mechanism which can take the form of i) conversion into CET1, or ii) permanent or temporary reduction of the principal. The instruments are not collateralised or subject to a guarantee or to an arrangement designed to enhance their seniority. Finally, according to Article 63 CRR, T2 instruments share most of the AT1 instruments eligibility criteria, but, in contrast to the latter, they must have a minimum maturity of 5 years and no incentive to redeem. Payments can be cumulative. T2 instruments are subordinated to depositors and senior creditors, and they only participate in absorbing losses in the event of liquidation (‘gone concern’ capital).

In contrast to CET1 instruments, the CRR does not foresee a mandatory pre-approval for AT1 and T2 instruments. However, Recital 75 CRR leaves open the possibility for NCAs to introduce a pre-

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[721] The ECB-SSM will need to clarify in a public policy stance the meaning of the indent ‘*sufficiently in advance*’ under the revised version of Article 26.3 CRR.
[722] Article 79a CRR II. For a discussion of the minimum requirement for own funds and eligible liabilities, see Chapter 3, Paragraph V.
[723] Article 28.3 CRR II.
[724] See Chapter 1, Paragraph 2.1.2., for AT1 instruments, and Chapter 1, Paragraph 2.1.3., for T2 instruments.
[725] Including an undertaking in which the institution holds a participation in the form of ownership, directly, indirectly or by way of control, of 20% or more of the voting rights or capital of that undertaking. See Article 52.1 (b) (ii) CRR.

approval mechanism[726]. Accordingly, on 6 June 2016, the ECB-SSM, as competent supervisor within the Banking Union, issued a public guidance on the review of the qualification of capital instruments as AT1 and T2 instruments[727] (the '**ECB Guidance**'). The ECB Guidance lays down the procedure followed by the ECB in reviewing the qualification of capital instruments as AT1 and T2 instruments, and it specifies the information that should be provided by SIs that compute the capital instruments towards their AT1 or T2 capital on an individual, sub-consolidated and/or consolidated basis[728]. At the same time, the ECB Guidance is without prejudice to national requirements in respect of the recognition of AT1 or T2 instruments. If national law requires pre-approval, the ECB is competent to grant such pre-approval to SIs[729]. Currently, such mandatory pre-approval requirement is set out under Spanish[730], Luxemburgish[731] and Slovenian[732] law. Such mandatory pre-approval on capital instruments represents a further example of the application by the ECB-SSM of purely national supervisory powers by virtue of Article 4.3 SSMR[733]. Banks established in these jurisdictions, therefore, must seek supervisory pre-approval before computation of AT1 or T2 instruments in their regulatory capital. In case they would not do so, ECB sanctioning powers may apply[734]. For banks established in other SSM jurisdictions, the ECB Guidance recommends that, as soon as a capital instrument is computed towards an entity's AT1 or T2 capital, the Chief Executive Officer, or, alternatively, a person duly authorised by the bank's management body, should send communication to the coordinator of the relevant Joint Supervisory Team (**JST**).

The letter from the SI shall, among others, i) specify the reasons for the issuance of the capital instrument and a description of the impact on own funds (CET1, Tier 1 and total capital) and on the leverage ratio (for AT1 instruments), ii) provide a description of the main features of the capital instrument, iii) include a self-assessment, performed by the SI, of the capital instruments against the requirements set out under the CRR and the RTS on Own Funds (taking into consideration also relevant EBA Q&As). No formal supervisory decision is adopted by the ECB. This non-binding 'confirmation procedure' is without prejudice to the ECB supervisory powers to carry out at any time carry out an *ex-post assessment* of AT1 and T2 instruments included by SIs in their capital against the CRR eligibility criteria and prescribed ratios. If such review concludes that a capital instrument is not eligible or is no longer eligible in accordance with Articles 55 or 65 CRR, the capital instrument

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[726] Recital 75 CRR reads: '*This Regulation should not affect the ability of competent authorities to maintain pre-approval processes regarding the contracts governing Additional Tier 1 and Tier 2 capital instruments. In those cases, such capital instruments should only be computed towards the institution's Additional Tier 1 capital or Tier 2 capital once they have successfully completed these approval processes.*'.

[727] ECB Public Guidance on the review of the qualification of capital instruments as Additional Tier 1 and Tier 2 instruments, 6 June 2016.

[728] The ECB recommends SIs follow its Guidance with respect to capital instruments issued after its date of publication. See Section II ECB Guidance.

[729] This is due to the application of national laws by the ECB under Article 4.3 SSMR. See Chapter 2, Paragraph 3.3.

[730] First additional provision of the Spanish Royal Decree 84/2015 of 13 February 2015.

[731] Article 3 of the Luxembourg *Commission de Surveillance du Secteur Financier Regulation* n°14-01 on the implementation of certain discretions of Regulation (EU) No 575/2013

[732] Article 129.2 of the Banking Act (ZBan-2).

[733] See Chapter 2, Paragraph 3.3.

[734] See Chapter 3, Paragraph IV.

and the related part of the share premium account immediately cease to qualify as AT1 or T2 capital, respectively[735].

[735] As the ECB specifies in its Guidance (section IV), an informal dialogue on the specific features of a capital instrument is encouraged between a SI's representatives and the relevant JST before issuance, in particular when the instrument to be issued has new or complex features. This informal dialogue, however, does not represent an approval (either explicit or implicit) of any instruments, or confirmation of their eligibility as an AT1 or T2 instrument.

Features	CET1 instruments – Article 28 (1) CRR	AT1 instruments – Article 52 (1) CRR	T2 instruments – Article 63 CRR
Issuance	**Directly** issued by institution and paid up	Issued and paid up	
Funding	Instruments not funded **directly or indirectly** by the institution.	Instruments not funded **directly or indirectly** by the institution and **not purchased** by: - the institution or its subsidiaries; - an undertaking in which the institution holds a participation in the form of ownership, directly, indirectly or by way of control, of 20% or more of the voting rights or capital of that undertaking.	
Level of subordination	**Rank below all other claims** in the event of insolvency or liquidation. The holders are entitled to a claim on the residual assets of the institution in the event of liquidation.	**Rank below Tier 2** in the event of insolvency of the institution.	The principal amount of the instruments is **wholly subordinated** to claims of **all non-subordinated creditors**.
	Instruments that are not collateralised or subject to a guarantee or to an arrangement designed to enhance their seniority.		
Permanence	**Perpetual instruments**	**Perpetual instruments** and **no incentive to redeem** clause	**Minimum initial term of five years** and **no incentive to redeem** clause
Flexibility of payments	Distributions under the instrument must meet the following conditions: - there is no preferential treatment regarding the order of distribution payments; - they may be paid only out of distributable items; - there is no cap or other restriction on the maximum level of distributions; - the level of distributions is not determined on the basis of the amount for which the instruments were purchased at issuance; - the conditions governing the instruments do not include any obligation for the institution to make distributions to their holders, and the institution is not otherwise subject to such an obligation; - non-payment of distributions does not constitute an event of default of the institution; - the cancellation of distributions imposes no restrictions on the institution.	Distributions under the instrument must meet the following conditions: - they are paid out of distributable items; - the level of distributions made on the instruments will not be amended on the basis of the credit standing of the institution or its parent undertaking; - the institution may at any time cancel the distributions on the instruments for an unlimited period and on a non-cumulative basis; - cancellation of distributions does not constitute an event of default of the institution; - the cancellation of distribution imposes no restrictions on the institution.	The holders do not have the right accelerate the future scheduled payment of interest or principal, other than in the insolvency or liquidation of the institution. The level of distributions made on the instruments will not be amended on the basis of the credit standing of the institution or its parent undertaking.
Loss absorption	**Absorption of the first and proportionately greatest share of losses.**	Upon the occurrence of a **trigger event,** the principal amount of the instruments is **written down on a permanent or temporary basis** or the instruments **are converted to CET1.**	**T2 instruments only participate in absorbing losses in the event of liquidation.**

Figure 11. *Overview of the main eligibility criteria of CET1, AT1 and T2 instruments (not applicable to non-joint stock companies)*

2.3. Own funds reductions

In light of the primary importance that high-quality and transparent banks' capital requirements bear before financial markets, investors and depositors, the general principle under the CRR framework is that EU credit institutions need to seek prior supervisory approval from the competent supervisor before reducing their own funds and eligible liabilities[736]. This is also consistent with the corresponding power of NCAs to authorise the classification of financial instruments as banks' regulatory capital. The CRR makes a distinction between own funds reduction with replacement[737] and own funds reduction without replacement[738]. In the former case, the credit institution submits to the relevant NCA an application for permission to reduce its own funds through the reduction, repurchase, call, redemption[739] of a certain amount of CET1, AT1 or T2 instruments with the aim to replace it with other eligible financial instruments. In the latter case, the applicant does not aim at substituting the redeemed financial instruments[740].

Within the Banking Union, the ECB-SSM may authorise a SI to reduce own funds with replacement only if i) the redeemed own funds will be replaced by instruments of equal or higher quality in an amount equal to or exceeding the amount of the own funds reduction, and ii) the terms and conditions of the replacing financial instruments meet the relevant eligibility criteria. Moreover, the SI needs to demonstrate that the replacement will take place earlier than or at the same time as the reduction of own funds, and that the replacement will take place on terms that are sustainable in relation to the SI's income capacity. In case of own funds reductions with replacement, the objective of the supervisor is to ensure that the applicant will have the same amount of regulatory capital and will still meet the CRR minimum capital requirements also following the reduction.

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[736] Article 77 CRR II reads: '*1. An institution shall obtain the prior permission of the competent authority to do any of the following:*
(a) reduce, redeem or repurchase Common Equity Tier 1 instruments issued by the institution in a manner that is permitted under applicable national law;
(b) reduce, distribute or reclassify as another own funds item the share premium accounts related to own funds instruments;
(c) effect the call, redemption, repayment or repurchase of Additional Tier 1 or Tier 2 instruments prior to the date of their contractual maturity.
2. An institution shall obtain the prior permission of the resolution authority to effect the call, redemption, repayment or repurchase of eligible liabilities instruments that are not covered by paragraph 1, prior to the date of their contractual maturity'.

[737] Article 78.1 (a) CRR.

[738] Article 78.1 (b) CRR.

[739] Article 78.1 CRR makes reference to the possibility for EU banks to '*reduce, call, redeem, repay or repurchase*' financial instruments without putting forward any clear distinction between these terms. For consistency purposes, in the context of this work we will use the term '*redemption*' and the verb '*redeem*', which will refer to all aforementioned concepts, unless expressly stated otherwise.

[740] As much as in the case of classification of financial instruments as CET1 capital, also the supervisory power now to be exercised by the ECB-SSM to authorise own funds reductions has already generated legal proceedings before European Courts. In Case T-203/18 (*VQ v. ECB*), VQ (a SI that met the size significance criterion, whose statutory name has been anonymised) challenged the legality of a ECB supervisory decision in which the ECB found that VQ had negligently committed an infringement by repurchasing its own shares without having sought the prior permission of the ECB in breach of Article 77 (a) CRR. The ECB imposed on VQ an administrative pecuniary penalty of €1,600,000 corresponding to 0.03% of its turnover. VQ disputed that it had committed an infringement and the proportionality of imposing a pecuniary penalty. In its judgment dated 8 July 2020, the General Court rejected all of the pleas in law put forward by the applicant. It found, *inter alia*, that the ECB did not fail to comply with the principle of proportionality by imposing on the applicant an administrative pecuniary penalty given that there is no reasonable doubt as to the interpretation of Article 77 (a) CRR. The case is closed as no appeal has been lodged before the CJEU. See General Court, Case T-203/18 (*VQ v. ECB*), 8 July 2020, ECLI:EU:T:2020:313.

In the case of own funds reduction without replacement, the ECB-SSM may grant permission only if it positively assesses that the own funds of the applicant SI will exceed, on a consolidated basis, the minimum capital requirements laid down in Article 92.1 CRR together with the combined buffer requirement as defined under Article 128.6 CRD IV[741]. Under this perspective, one may also argue that the relevant SI's capital ratios, in order for the own funds permission to be granted, will also need to exceed the additional capital requirements, if any, laid down by the ECB-SSM in its annual SREP supervisory decision[742].

Against this backdrop, the CRR II introduces two noteworthy flexibility clauses in the EU capital adequacy framework as regards own funds reductions. First, it introduces the possibility for banks, under certain conditions, to apply for a general permission to reduce own funds[743]. In particular, if a SI provides sufficient safeguards as to its capacity to operate with own funds above the minimum requirements required under the CRR-CRD, the ECB may grant that institution a general prior permission to reduce own funds (with or without replacement), provided that such reduction is line with the aforementioned requirements for own funds reduction (with or without replacement). This general prior permission may be granted by the ECB only for a specified period of time extendible to one year, after which the permission may be renewed. In addition, such general prior permission may be granted only for a predetermined amount of financial instruments, which shall be set by the ECB[744]. The ECB may withdraw its general prior permission at any time where a SI breaches any of the legal requirements provided for own funds reductions or the ECB conditions under such permission. Second, the CRR II introduces the possibility for SIs to apply for reduction of AT1 and T2 instruments within the first five years after issuance if i) the replacing instrument is of higher quality and sustainable for the income capacity, and ii) the replacement is prudentially beneficial and justified by exceptional circumstances[745].

2.4. Own funds delegated supervisory decisions

As discussed under Chapter 2[746], to ensure a more efficient functioning of the SSM and enable the Supervisory Board (**SB**) to dedicate sufficient time to more complex and urgent supervisory matters, the Governing Council (**GovC**) of the ECB has decided, under the general framework laid down by the ECB Decision 2017/933 on the delegation of decision-making powers[747], to delegate the adoption of certain routine supervisory decisions to the heads of ECB-SSM internal Directorates Generals (**DGs**). In particular, the GovC, also in light of the significant number of own funds decisions that the

[741] The combined buffer requirement is defined as the total CET1 capital required to meet the requirement for the capital conservation buffer extended by the following, as applicable: i) the institution-specific countercyclical capital buffer, ii) the G-SIB buffer, iii) the O-SIB buffer, and iv) the systemic risk buffer. For an overview of the macroprudential capital buffers, see Chapter 2, Paragraph 2.3.1.
[742] See Chapter 3, Paragraph III.
[743] Article 78.1 CRR II.
[744] According to Article 78.1 CRR II, in the case of CET1 instruments, that predetermined amount shall not exceed, in any case, 3% of the relevant issue and 10% of the amount by which CET1 capital exceeds the sum of CRR-CRD minimum capital requirements by a margin that the ECB considers necessary. In the case of Additional Tier 1 or Tier 2 instruments, that predetermined amount shall not exceed 10% of the relevant issue and 3% of the total amount of outstanding AT1 and T2 instruments, as applicable.
[745] Article 78.4 (d) CRR II.
[746] See Chapter 2, Paragraph 4.2.
[747] Decision (EU) 2017/933 of the ECB of 16 November 2016 on a general framework for delegating decision-making powers for legal instruments related to supervisory tasks (ECB/2016/40).

ECB-SSM adopts every year[748], has decided, through ECB Decision (EU) 2018/546 (the '**own funds delegation decision**')[749], to establish a dedicated SSM-internal delegated decision-making procedure as regards the adoption own funds supervisory decisions. The criteria for the supervisory assessment remain unchanged, as set out under the CRR and the RTS on Own Funds[750]. However, under at least three different circumstances, own funds supervisory decisions cannot be delegated to ECB-SSM heads of working units: i) the supervisory decision is negative, i.e. the decision does not or does not fully grant supervisory approval[751], ii) the supervisory decision is conditional, unless the addressee has accepted the ancillary provisions in writing, or the ancillary provisions merely mirror a legal requirement, or the ancillary provisions could also be qualified as a request for information[752], and iii) insufficient information was provided by the applicant, or the complexity of the assessment require the adoption of the supervisory decision under the non-objection procedure[753].

According to Article 2 own funds delegation decision, supervisory decisions subject to delegation are: (a) the prior permission for the classification of capital instruments as CET1 capital, where the criteria under Article 3 own funds delegation decision are met, (b) the prior permission for the classification of capital instruments as AT1 or T2, where required by national law and where the criteria under Article 4 own funds delegation decision are met, and (c) the prior permission for own funds reductions, where the criteria under Article 5 own funds decision are met. As discussed under Chapter 2, to operationalise the delegated decision-making process, the EB has to adopt a decision be means of which it nominates the ECB heads of work units in charge of adopting delegated supervisory decisions. Accordingly, the EB adopted Decision (EU) 2020/1333 (the '**own funds nomination decision**')[754]. Pursuant to Article 1 of the own funds nomination decision, delegated supervisory decisions shall be adopted by:

a) the Director-General[755], or the Deputy Director-General, of the Directorate-General Systemic and International Banks (**DG/SIB)**, if supervision of the relevant supervised entity is carried out by a JST embedded into such DG;
b) the Director-General[756], or the Deputy Director-General, of the Directorate-General Universal and Diversified Institutions (**DG/UDI)**, if supervision of the relevant supervised entity is carried out by a JST embedded into such DG;
c) the Director-General[757], or the Deputy Director-General, of the Directorate-General Specialised Institutions and Less Significant Institutions (**DG/SPL**), if supervision of the relevant supervised entity is carried out by a JST embedded into such DG.

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[748] In 2019, the ECB issued 2,356 supervisory decisions addressed to specific supervised entities. Of these, own funds decisions amount to 7.0%, second to only fit and proper assessments (47.3%), SREP (8.6%) and internal models (7.5%). See ECB (Mar 2019).
[749] Decision (EU) 2018/546 of the European Central Bank of 15 March 2018 on delegation of the power to adopt own funds decisions (ECB/2018/10).
[750] See Chapter 3, Paragraphs 2.1., 2.2. and 2.3.
[751] See Articles 3, 4 and 5 own funds delegation decision.
[752] See Recital No 14 own funds delegation decision.
[753] See Article 2.3 own funds delegation decision.
[754] Decision (EU) 2020/1333 of the European Central Bank of 15 September 2020 nominating heads of work units to adopt delegated own funds decisions and repealing Decision (EU) 2018/547 (ECB/2020/41).
[755] Currently, Ramón Quintana.
[756] Currently, Korbinian Ibel.
[757] Currently, Patrick Amis.

According to Article 3 own funds delegation decision, supervisory decisions on the classification of capital instruments as CET1 capital shall be taken by means of a delegated decision if the type of instruments in respect of which prior permission is sought has been included, at the time the application was received by the ECB, in the EBA list of CET1 instruments.

According to Article 4 own funds delegation decision, where prior permission is required under national law, positive decisions on prior permission to classify capital instruments as AT1 and T2 instruments shall be taken by means of a delegated decision.

According to Article 5.2 own funds delegation decision, supervisory decisions on the reduction of own funds with replacement shall be taken by means of a delegated decision if: i) the replacing instrument is a CET1 instrument with an aggregate nominal amount at least equal to the nominal amount of the replaced instrument, ii) the replacing instrument is an AT1 instrument with an aggregate nominal amount at least equal to the nominal amount of the replaced instrument, if the replaced instrument is an AT1 instrument, or iii) the replacing instrument is an AT1 or T2 instrument with an aggregate nominal amount at least equal to the nominal amount of the replaced instrument, if the replaced instrument is a Tier 2 instrument.

According to Article 5.3 own funds delegation decision, supervisory decisions on the reduction of own funds without replacement shall be taken by means of a delegated decision if: i) following the reduction, the own funds exceed and are estimated to continue exceeding, for at least three financial years after the date of the application, the sum of Pillar 1 CRR minimum capital requirements[758] and the combined buffer requirement[759], as well as the additional Pillar 2 own funds required to be held by the ECB (e.g. through the SREP) and the Pillar 2 capital guidance as set out in the last available SREP decision, and ii) the impact of the reduction on the relevant tier of capital is below 100 basis points.

2.5. Authorization to the use of internal ratings-based models

As discussed under Chapter 1, capital adequacy requirements are widely accepted to be the most effective tool to ensure the stability and soundness of financial institutions[760]. The determination as well as the level of appropriate capital charges, however, is subject to much debate. Market forces alone do not incentivize banks to hold sufficient capital because implicit and explicit guarantees provide banks with an incentive to hold less capital than is socially optimal. However, regulating capital via a simple capital to asset ratio incentivizes banks to hold portfolios with more risky assets. Capital regulations with little risk sensitivity, as it was the case under Basel I[761], share a 'flat tax' feature and incentivize banks to increase asset risk within each risk category, thus leading to a distortion in the allocation of credit.

Consequently, international standard-setters and regulators have introduced new regulatory measures to link capital charges to asset risk. The Basel II framework, the most important of such efforts, introduced capital charges for individual loans that depend on risk estimates from banks'

[758] Article 92.1 CRR.
[759] Article 128 (6) CRD IV.
[760] See, among others, Behn et al. (2016); Huizinga (2016); McNamara et al. (2014).
[761] See Chapter 1, Paragraph 1.3.

internal risk models. As discussed[762], the introduction of model-based capital regulation has been an important regulatory innovation targeted at incentivising banks to adopt stronger risk management practices, and – ultimately – increasing the stability of the banking system. Following the transposition of Basel II into national frameworks, banks could choose between the IRB approach, in which capital charges depend on internal risk estimates of the bank, and the less risk-sensitive SA, which does not rely on internal risk parameters. The introduction of IRB required a sophisticated risk management system that had to be certified by the regulator. As a consequence, mostly large banks found it worthwhile to introduce the IRB approach, while most small banks preferred the SA to determine capital charges[763]. Banks that opted for IRB assess the credit risk of their customers with their own internal models which use banks' internal data in order to estimate key risk parameters such as the probability of customer defaults (**PD**), the loss in case of a default (**LGD**), and the exposure at default (**EAD**)[764]. In the Advanced IRB approach the bank estimates all parameters itself. In the Foundation IRB approach, banks' main input is the PD, while the other parameters are largely prescribed by the Basel framework and the CRR. The PD, LGD and EAD parameters are then entered into a formula in order to derive the RWAs that determine the regulatory equity requirements. All banks use the same formula, which is prescribed by the Basel framework[765].

In light of the above, it becomes apparent the most prominent role that risk measurement approaches, may they be SAs or internal ratings-based, play in modern banking supervisory law. As equity and subordinated capital instruments are the costliest prudential requirement introduced by the G-20 post-GFC regulatory agenda that banks must comply with, being capable of resorting to complex IT data-input methods and processes that support the assessment of banking risks and lower the quantification of defaults and loss estimates, and, hence, the level of RWAs, can be the discriminating factor between profitability and insolvency. As a consequence, to foster the highest level of transparency and consistency in risk modelling across credit institutions, the current CRR framework entrusts public administrative authorities with the power to authorise banks to use alternative models to the SA[766] and ensure, on an ongoing basis, compliance by banks with relevant prudential requirements. Within the Banking Union, this supervisory task is centralised to the ECB pursuant to Article 4.1 (d) SSMR[767]. In particular, Part III, Title II, Chapter 3 CRR provides the ECB with the power to authorise SIs to use, or to implement material changes to it, the individual IRB model that the applicant aims at using to calculate capital to cover for a specific banking risk. Accordingly, Article 143.1 CRR stipulates that the ECB shall grant permission to SIs to use the IRB approach for credit risk. Moreover, Article 143.3 CRR lays out that the relevant SI shall obtain the

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[762] See Chapter 1, Paragraph 1.4.
[763] See Behn et al. (2016), p. 27.
[764] When using the IRB measurement approaches to determine capital requirements, the risk components for a given exposure that banks needs to estimate are: i) the probability of default (**PD**), ii) the loss given default (**LGD**), iii) the exposure at default (**EAD**). The PD defines the average percentage of obligors that default in a rating grade in the course of one year; the LGD indicates the percentage of exposure a bank may lose when a borrower defaults; the EAD is the outstanding nominal value a bank is exposed to when a loan defaults. See BCBS (Jun 2004), para. 211 ff.
[765] For an analysis of the different risk measurement approaches under the Basel framework (SA and IRB), and a discussion of the Basel IV reform, see Haselmann and Wahrenburg (2016).
[766] Article 111 CRR.
[767] See Chapter 2, Paragraph 3.1.1.

ECB prior permission to implement any material changes or extensions[768] to i) the rating system[769], or ii) the internal models approach to equity exposures, which the bank was previously authorised to use under Article 143.1 CRR. In substance, in case banks were to use the IRB model for credit risk, Article 143 CRR covers both scenarios relating to the initial authorisation to the use of the model as well as the implementation of any material change to it. Prior permission to use the IRB approach shall be required for each exposure class, rating system and internal models approaches to equity exposures, as well as for each approach to estimating LGDs and conversion factors (**CFF**)[770] used.

The ECB may grant the authorisation to the relevant SI to use the IRB approach only if the bank meets the CRR prudential requirements[771] and the ECB is satisfied that the systems of the credit institution for the management and rating of credit risk exposures are sound and implemented with integrity. In particular, the applicant shall demonstrate to the satisfaction of the ECB that[772]:

1) its rating systems provide for a meaningful assessment of obligor and transaction characteristics, a meaningful differentiation of risk and accurate and consistent quantitative estimates of risk;
2) the internal ratings and default and loss estimates used in the calculation of own funds requirements and associated systems and processes play an essential role in the risk management and decision-making process, and in the credit approval, internal capital allocation and corporate governance functions of the bank;
3) it has a credit risk control unit responsible for its rating systems that is appropriately independent and free from undue influence;
4) it collects and stores all relevant data to provide effective support to its credit risk measurement and management process;
5) it documents its rating systems and the rationale for their design and validates its rating systems;
6) it has validated each rating system and each internal models approach for equity exposures during an appropriate time period prior to the permission to use this rating system or internal models approach to equity exposures, it has assessed during this time period whether the rating system or internal models approaches for equity exposures are suited to their range of application, and it has made necessary changes to these rating systems or internal models approaches following from its assessment;

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768 The assessments criteria to determine the materiality of a change or extension to the IRB model that would require prior supervisory approval are specified under Commission Delegated Regulation (EU) No 529/2014 of 12 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach.

769 Under Article 142 CRR, a 'rating system' is defined as '*all of the methods, processes, controls, data collection and IT systems that support the assessment of credit risk, the assignment of exposures to rating grades or pools, and the quantification of default and loss estimates that have been developed for a certain type of exposures*'.

770 CFF calculate the amount of off-balance-sheet transactions (with the exception of derivatives) to an EAD amount. In this sense, they serve the purpose to convert off-balance sheet assets or liabilities (where the bank, normally, did not experience immediate cash outflows) to an amount equivalent to a loan exposure (on-balance sheet) under credit risk. In this sense, CCFs can be seen as probability of off-balance sheet exposure converting into a loan on-balance sheet asset or product.

771 Articles 169 to 191 CRR.

772 Article 144 CRR.

7) it has calculated under the IRB approach the own funds requirements resulting from its risk parameters estimates and is able to submit the reporting as required by Article 99 CRR[773].

In addition to the aforementioned requirements, the CRR stipulates[774] that a SI applying to use the IRB approach shall have been using, for the IRB exposure classes in question, rating systems that were broadly in line with the CRR prudential requirements for at least three years prior to the submission of the application to the ECB to use the IRB approach[775]. Where the SI extends the use of the IRB approach subsequent to its initial permission, the three years-time experience in using IRB rating systems is considered to be sufficient also in respect of the additional exposures covered, unless the use of rating systems is extended to exposures that are significantly different from the scope of the existing coverage. In such a case, the existing experience cannot be reasonably assumed to be sufficient to meet the CRR three years-time experience requirement. Therefore, the SI shall need to demonstrate to the satisfaction of the ECB that it has been using, for the additional exposure classes it intends to request the extension of the use of the IRB model to, rating systems that were broadly in line with the CRR prudential requirements for at least three years[776]. Importantly, the CRR lays out the anti-circumvention rule[777] according to which the credit institution that has been authorised to use the IRB approach shall not stop using that approach unless i) it receives prior supervisory approval, and ii) it demonstrates to the satisfaction of the NCA that the use of the SA is not proposed to reduce its own funds requirement, is necessary on the basis of nature and complexity of its total exposures, and would not have a material adverse impact on its solvency and ability to manage risk effectively[778].

Similarly, the CRR stipulates that banks shall seek prior supervisory approval to use the IRB model to calculate capital to cover for i) counterparty credit risk[779], ii) credit value adjustment (**CVA**) risk[780], iii) operational risk (as regards either initial permission and material changes)[781], and iv) market risk[782].

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[773] As discussed under Chapter 2, the reporting data on own funds under Article 99 CRR are key to the determination of the size of the bank and, hence, its qualification or not as 'significant' under the SSMR significance criteria.
[774] Article 145.1 CRR.
[775] The same applies with regard to own estimates of LGDs and CFF. See Article 145.2 CRR.
[776] Article 145.3 CRR.
[777] Article 149 CRR.
[778] The CRR anti-circumvention rule applies in respect of the full spectrum of banking risks. See, for instance, Article 313.3 CRR on reverting to the use of less sophisticated approaches for operational risk.
[779] Article 283.1 CRR. As the CRR, in contrast to credit risk and market risk, did not mandate the EBA to adopt a regulatory technical standards (**RTS**) to determine assessment criteria as regards the materiality of a change or extension also in relation to the IRB approach to cover for counterparty credit risk, in September 2017 the ECB published its policy stance, which recommends SIs to follow, as a Guide on materiality assessments for the IRB model extensions and changes to counterparty credit risk. See ECB (2017).
[780] Article 383 CRR. Banks that undertake derivative or securities financing transactions are subject to the risk of incurring mark-to-market losses because of the deterioration in the creditworthiness of their counterparties (which can include sovereigns, banks, other financial institutions and non-financial corporations). This potential source of loss due to changes in counterparty credit spreads and other market risk factors is known as CVA risk. CVA risk is complementary to the risk of a counterparty defaulting, or counterparty credit risk.
[781] Article 312.2 CRR.
[782] Article 363.1 CRR requires supervisory approval to the use of the IRB model, whereas Article 363.3 CRR requires supervisory approval to implement material changes to the IRB approach.

III. The ECB-SSM Supervisory Review and Evaluation Process

3.1. Origin and legal basis

As discussed under Chapter 1[783], the concepts of Pillar 2 and supervisory review and evaluation process (**SREP**) were introduced into international banking regulation by the Basel II Accord in 2004. The objectives were ambitious: to incentivise financial institutions to better measure and manage their risks, and to make capital requirements more risk-sensitive than under the previous rules. Indeed, international standard-setters acknowledged that – although more complex and risk-sensitive than before – Pillar 1 requirements for credit, counterparty, market and operational risks were not (and could not be) fully sufficient to capture a bank's risk profile. In other words, in the view of the BCBS, the banking business is so complex and the risks are so heterogeneous that the first line of defence is proper risk quantification and management by the banks themselves. Therefore, the key idea underpinning Basel II was to complement the minimum capital requirements prescribed by regulators (Pillar 1) with tailored supervisory measures based on a thorough analysis of the bank's riskiness, including a review of its self-assessment (Pillar 2)[784]. The SREP was meant to be carried out against the banks' self-assessments known as internal capital adequacy assessment process (**ICAAP**)[785], and supervisors had to focus, in particular, on interest rate risk on the banking book, credit risk (including concentration risk), operational risk, and risk due to securitisations.

With the CRD I, which together with Directive 2006/49/EC transposed the Basel II Accord into EU law, the scope of the SREP (therein termed '*review and evaluation performed by competent authorities*') was somewhat broadened, making reference also to market risk and liquidity risk. The focus of the SREP was, then, significantly enhanced by the CRD IV, which, together with the CRR, implemented the 2010 Basel III Accord in the EU[786]. Articles 97 ff. CRD IV state that competent authorities must review all '*the arrangements, strategies, processes and mechanisms implemented by the institutions*' to comply with the CRD package prudential requirements. This includes, among others, '*the business model of the institution*', '*a comprehensive assessment of the overall liquidity risk management*', '*governance arrangements*' and '*the ability of members of the management body to perform their duties*'[787]. The SREP must also take into account the results of the supervisory stress tests performed by banks, including the EU-wide exercises periodically run under the supervision of the EBA[788]. Moreover, Articles 104 and 105 CRD IV enumerate a wide array of supervisory actions that NCAs may use whenever the SREP results suggest that institutions breach, or are about to breach, the requirements set out by CRD package. This includes additional capital buffers, *ad hoc* liquidity requirements, supplementary disclosure obligations and other qualitative measures[789].

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[783] See Chapter 1, Paragraph 1.4.
[784] On the SSM implementation of the Basel II Pillar 2, also in a comparative perspective with the US and UK, see Bevilacqua et al. (2019).
[785] The ICAAP was complemented by the internal liquidity adequacy assessment process (**ILAAP**) to manage liquidity risks.
[786] On the Basel III Accord, see Chapter 1, Paragraph II. On the EU implementation of Basel III through the CRD IV and CRD V package, see Chapter 3, Paragraph I.
[787] On the evolution of the SREP within the EU, and for an analysis of the first two ECB SREP cycles, see Resti (2018).
[788] For an analysis of the EU-wide EBA stress tests, see Chapter 2, Paragraph 3.1.3.
[789] Within the Banking Union, the possibility for the ECB-SSM to uniformly adopt quantitative and qualitative supervisory measures without having to apply the national laws implementing the CRD IV is ensured by Article 16.2

3.2. Structure and methodology of the SREP: A 'holistic approach'

Since its launch in November 2014, the SSM has devoted considerable effort to the development of a harmonized Pillar 2 framework. This has been a true challenge, given the diversity of national practices across jurisdictions[790] and the heterogeneity of Eurozone banking sectors. As it is the case in every EU jurisdiction, the application of the SREP within the SSM is primarily based on the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (the '**SREP Guidelines**')[791]. The SREP Guidelines are addressed to supervisory authorities across the EU, i.e. the ECB and the NCAs, and are intended to provide a common framework for prudential authorities to assess in a thorough fashion the risks that banks they supervise face in their business operations. Accordingly, the SREP Guidelines establish a consistent supervisory culture implementing the wider Pillar 2 components of the Basel framework into EU legislation.

Within the Banking Union, the ECB-SSM carries out the yearly SREP cycle following a holistic, forward-looking approach[792]. In particular, the ECB-SSM SREP[793] has three main outcomes: i) a holistic, forward-looking assessment of the overall viability of each supervised entity, ii) the adoption of a supervisory decision requiring – where needed – banks to meet additional capital and/or liquidity buffers, and implement other supervisory measures, and iii) an input to the determination of the minimum level of supervisory engagement for a specific institution as part of the next Supervisory Examination Programme (**SEP**)[794].

Based on a categorisation of institutions and the monitoring of key indicators, the SSM-ECB SREP is organised around the four following main elements, which cover all major drivers of bank riskiness:

1) a business model and profitability assessment;
2) an internal governance and risk management assessment;
3) an assessment of risks to capital on a risk specific basis: i.e. credit risk, market risk, operational risk, interest rate risk in the banking book (**IRRBB**) and the institution's internal identified risks in normal scenarios and under stressed conditions[795];
4) an assessment of risks to liquidity and funding on a risk specific basis: short-term funding, long-term funding, the institution's internal identified risks in normal scenarios and under stressed conditions[796].

SSMR, which mimics the scope of Article 104 CRD IV but, being a Regulation, is directly applicable. See Chapter 2, Paragraph 3.2.1.

[790] See Nouy (2017).

[791] The mandate for the EBA to publish these guidelines is set out in Article 107.3 CRD IV, which also mandates the EBA to annually report to the EP and the Council on the level of convergence achieved among EU NCAs. See EBA, *Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing - Consolidated version*, EBA/GL/2014/13, 19 July 2018.

[792] See ECB (Jan 2020).

[793] For a detailed analysis of the ECB-SSM SREP, see also Meissner (2016).

[794] For a discussion on how the institution-specific SEP integrates into ongoing ECB-SSM supervision by the JSTs, see Chapter 2, Paragraph 1.1.2.

[795] These assessments feed into an assessment of capital adequacy and a preliminary determination of a possible imposition of Pillar 2 capital requirement to cover for risks not fully captured under Pillar 1. See ECB (Jan 2020).

[796] As much as in the case of capital adequacy, these assessments feed into a preliminary determination of a possible Pillar 2 liquidity requirement to cover for liquidity risks not fully captured by the LCR and the NSFR under Pillar 1.

These four supervisory examinations shall constitute the core SREP elements[797]. As the ECB recognises that the overall risk profile of a credit institution is multifaceted and that the single risk factors are closely interrelated, the four SREP elements are looked at together when drawing up the overall assessment for the relevant SI and preparing the SREP supervisory decision[798]. In other words, adopting what the ECB calls a 'holistic approach'[799]. For each element, the evaluation is conducted through a dedicated risk assessment system (**RAS**). Under the SREP Guidelines, competent authorities shall monitor financial and non-financial key indicators on a quarterly basis in order to identify changes and anomalies of the financial situation or risk profile of an institution early on[800]. Accordingly, the RAS is fed with regular reporting, such as common reporting (**COREP**)[801] and financial reporting (**FINREP**), and qualitative information, and also includes *ad hoc* information obtained by JSTs from various sources on an ongoing basis[802].

As a key building block of the SREP, the SREP Guidelines provide for a categorisation of credit institutions under the remit of each NCA. The categorisation should reflect the assessment of systemic risk posed by banks to the financial system[803]. The purpose of such categorisation is that it should serve as a benchmark to EU supervisory authorities (including the ECB) for applying the principle of proportionality and, thus, better calibrating Pillar 2 supervisory measures. Under this perspective, banks should be allocated to four different categories on the basis of their size, structure, internal organization and the scope and complexity of their activities. According to this concept, the following four categories of institutions should have established under the ECB-SSM SREP[804]:

i. Category 1: institutions identified by the FSB/BCBS as G-SIBs, as well as EU O-SIBs as identified by NCAs, and, as appropriate, other institutions determined by the ECB;
ii. Category 2: i) medium to large institutions other than those in Category 1 that operate domestically or with sizable cross-border activities, operating in several business lines, including non-banking activities, and offering credit and financial products to retail and corporate customers, as well as ii) non-systemically important specialised institutions with significant market shares in their lines of business or payment systems, or financial exchanges;
iii. Category 3: i) small to medium institutions that do not qualify for Categories 1 or 2, operating domestically or with non-significant cross-border operations, and operating in a limited number of business lines, offering predominantly credit products to retail and corporate customers with

[797] See next Paragraph for a detailed analysis of each core SREP element.
[798] See Chapter 3, Paragraph 3.3.
[799] See Bevilacqua et al. (2019), p. 13.
[800] See EBA (Jul 2018), p. 39 ff.
[801] COREP is the standardised reporting framework issued by the EBA under the CRD IV. It aims at defining a common reporting framework to be used by credit institutions (and investment firms) when they report their solvency ratios to supervisory authorities. The objective is to achieve a high level of harmonization and a strong convergence of regular supervisory reporting requirements. COREP covers capital adequacy ratios under credit risk, market risk, operational risk and own funds. For each of these ratios, the EBA developed specific templates to be used by banks and are available on its website.
[802] These include other data (e.g. short-term exercise data), reports (e.g. external audit reports), meetings and inputs stemming from on-site supervision and/or deep-dive analysis.
[803] See EBA (Jul 2018), p. 27.
[804] See EBA (Jul 2018), p. 27 ff. It is worth mentioning that, however, the ECB does not release publicly available information according to which it seems to take into account such categorisation rule laid out by the EBA in the SREP Guidelines.

a limited offering of financial products, as well as ii) specialised institutions with less significant market shares in their lines of business or payment systems, or financial exchanges; and

iv. Category 4: all other small non-complex domestic institutions that do not fall into Categories 1–3, for example with a limited scope of activities and non-significant market shares in their lines of business[805].

The minimum level of supervisory engagement and dialogue for Category 1 and 2 institutions shall be an ongoing engagement with the institutions' management body and senior management and shall include an assessment of each of the four SREP core elements: business model analysis, assessment of internal governance, assessment of risks to capital and assessment of risks to liquidity and funding. With respect to applicable timeframes, for Category 1 institutions the assessment of the four SREP elements shall occur annually, while for Category 2 institutions such assessment shall occur every two years. However, the underlying monitoring of key indicators shall occur quarterly for both Category 1 and 2 institutions.

On the other hand, the intensity of supervision for Category 3 and 4 institutions is reduced. The minimum level of supervisory engagement for Category 3 institutions shall be a risk-based engagement with the institution's management body and senior management as well as engagement with the institution for the assessment of material risk elements every three years. For Category 4 institutions, the supervisory requirement is an engagement with the institutions' management body and senior management at least every three years.

3.3. The core SREP elements

The first two core SREP element (i.e. business model and profitability analysis, and the internal governance and risk management analysis) are assessed according to a methodology based on three phases[806]. Phase 1 is defined as 'data gathering', that is relevant information is gathered and understood against the materiality of certain indicators relating to the business model of supervised entities. Phase 2 is defined as 'automated score', i.e. anchoring the SREP score based on selected financial indicators, such as return on assets and cost income ratio. The ECB-SSM SREP methodology ends with Phase 3, that is 'risk level assessment' (used to adjust Phase 2 score taking into consideration the banks' specifics[807]).

As regards the first core component of the SREP, i.e. business model analysis, the information gathering in Phase 1 comprises a quantitative and qualitative analysis of the business model. In this regard, sources of information relevant for the ECB include COREP and FINREP, the bank's strategic plans and forecasts, financial reporting, internal reporting at management level (focussing on capital, liquidity and risk), recovery and resolution plans, third-party reports (external annual audits, ratings) and other relevant studies and surveys at macroprudential level. Viability and sustainability of the SI's business model is at the centre of the ECB's supervisory action, which has outlined the following

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[805] More recently, a staggered approach has been conceived to foster a gradual harmonization of the SREP frameworks adopted at national level for the risk assessment of LSIs and align policies and methodologies to the ones used by the SSM for SIs. In this regard, every year the ECB updates and publishes a LSI SREP methodology booklet to promote supervisory convergence in the LSI sector while supporting a minimum level of harmonisation and a continuum in the assessment of SIs and LSIs. See ECB (2020). On the SSM SREP for LSIs, see also Huertas (2017).

[806] See ECB (Jan 2020).

[807] On Phase 3 of the SREP methodology, see also next Paragraph.

key areas for its analysis[808]: assessment of the business environment, analysis of the forward-looking strategy, assessment of the business model (viability within one year, sustainability within three years, cycle profitability in more than three years) and assessment of key vulnerabilities[809]. The automated score assigned in Phase 2 takes into account the peer group of the relevant SI (for example, where it is a custodian, diversified lender, retail lender, specialised lender, small universal bank or universal bank). The risk level assessment in Phase 3 is primarily based on viability, sustainability, cycle profitability and identified vulnerabilities. In this respect, viability indicators that can be considered by the ECB may be the position of the bank in the business cycle, its ability to generate acceptable returns over the following 12 months, its funding structure, its risk appetite and its risk capacity[810]. Sustainability depends on the bank's strategy to generate acceptable returns over the next three years taking into account customer behaviour, impacts of regulatory requirements and other future scenarios relevant for the bank[811].

With regard to the second core SREP element, i.e. internal governance and risk management, material aspects of the ECB assessment are the overall internal governance structure and reporting lines, the organisation and functioning of the management body, corporate and risk culture, the internal risk framework (notably, the ICAAP and ILAAP risk management processes), as well as key control functions (such as compliance[812] and internal audit), internal IT and information systems, remuneration policies as well as adequate recovery plan arrangements[813]. Therefore, the assessment of this core SREP element will address the question of whether the controls and governance are appropriate for the relevant SI and are meeting the BCBS international principles and CRR hard rules for these areas.

On the other hand, the assessment of risks to capital and risks to liquidity and funding (core SREP elements No 3 and 4) is performed in blocks and results in the possible determination of ranges of capital and liquidity requirements – e.g. a liquidity coverage ratio (**LCR**)[814]. This assessment is, therefore, based on the outcome of the ongoing RAS (first block), supplemented by a more comprehensive periodic review of the institution's capital and liquid positions, in the light of the SI's own assessments, i.e. ICAAP and ILAAP, (second block), and, last, the ECB's own quantifications

[808] See ECB (2018).
[809] Such exercise is particularly key in the context of the SREP as European banks currently suffer from evident subdue profitability. For a discussion of this issue, see Chapter 4, Paragraph 1.3.
[810] See Meissner (2016), p. 335.
[811] The analysis of cycle profitability looking forward beyond the next three years comprises more qualitative factors like analysis of competition, business plan assumptions and management track record. Examples for key vulnerabilities can be excessive concentrations or volatility, excessive risk taking, funding structure concerns or idiosyncratic economic factors. See Meissner (2016), p. 334.
[812] With regard to the compliance function, a key question the ECB has published in connection with the internal governance assessment in its SREP methodology booklet is the following: '*Is there a compliance function in place that is hierarchically and functionally separate and operationally independent from any business activity responsibilities?*'. See ECB (2018), p. 19. To comply with this standard, SSM credit institutions will have to implement at least three sets of rules. First, there are the BCBS' corporate governance principles for banks which now provide a relatively detailed framework for the compliance function based on the 'three lines of defence model' of risk management and put a particular emphasis on the separation of compliance from operative functions and require a direct reporting line to the banks' management. Second, the SREP itself sets forth a short yet clear framework for the compliance function with an overall compliance policy and acting permanently and effectively with a reporting line to the management. Third, national banking laws of EU Member States may also have rules for the compliance function of credit institutions.
[813] See EBA (Jul 2018).
[814] See Chapter 3, Paragraph 3.4.

under stressed conditions (third block). According to the ECB's methodology[815], the measuring of risk to capital follows three different perspectives. Such perspective are i) the supervisory perspective, ii) the bank's perspective, and iii) the forward-looking perspective. With regard to the supervisory perspective, the risk categories taken into account by the ECB are credit risk (whether under the SA or the IRB approach), market risk and operational risk. Second, the bank's perspective is primarily based on the ICAAP, while the forward-looking perspective is mainly based on the results of the bank's internal stress tests, as complemented by the EU-wide EBA stress test (or ECB supervisory stress tests) as anchoring assessment[816]. Therefore, from the relevant SI's perspective, the Pillar 1 quantification serves as starting point or floor for ICAAP. While supervisors may not dictate internal models used in the ICAAP, they should assess the reliability of the ICAAP calculations by introducing supervisory benchmarks in order to verify and, if necessary, to correct and substitute such calculations[817]. After the JST has assessed the three perspectives in a comprehensive manner, it obtains a view on whether own funds suffice to cover all banking risks to capital. Subsequently, it can compare these capital needs with the quantity and quality of capital the institution holds and plans to raise in the future. Based thereon, the JST can determine the overall capital requirement for the SI and propose it for adoption to the SB in the context of the approval of the SREP supervisory decision.

Similarly to the ECB's methodology for measuring the risk to capital, the assessment of risks to liquidity and funding also follows three different perspectives, which are the supervisory perspective, the bank's perspective and the forward-looking perspective. For the supervisory perspective, the risk categories considered in its assessment by the ECB are i) short term liquidity, and ii) funding sustainability. Also in this case, the SI's perspective is mainly based on the ILAAP, while the forward-looking perspective is primarily based on bank internal stress tests using supervisory stress tests as anchoring assessment. In the assessment of risks to liquidity, the ECB first identifies the short- and medium-term liquidity needs of the credit institution by calculating its liquidity availability over different time horizons and examining the adequacy of its LCR. Subsequently, an evaluation of the liquidity buffers and counterbalancing is conducted, followed by supervisory liquidity stress tests to confirm liquidity needs and the adequacy of the buffers. With respect to the assessment of risks to funding, the ECB first includes an analysis of the bank's funding profile and its stability. Subsequently, the current and future market access is examined, i.e. the volume of funding demands on certain markets or counterparties is compared to the capacities of these markets or institutions[818]. Finally, the supervisors should compare the funding risk to the bank's funding plan taking into account the supervisory view of the feasibility of such funding plan.

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815 See ECB (Jan 2020).

816 It is worth mentioning that only after the GFC supervisory stress tests have become an effective tool at disposal of prudential authorities, leading the BCBS and the Committee of European Banking Supervisors (**CEBS**) to issue the '*Principles for sound stress testing practices and supervision*' (2009) and the '*Guidelines on Stress Testing*' (2010) in order to harmonise the stress testing framework among banks and NCAs. Under Basel II, and prior to the outbreak of the GFC, supervisory stress tests had not yet been developed as a supervisory tool to assess a bank's resilience to withstand hypothetical and adverse scenarios. Rather, stress tests were conceived as a bank risk management tool, to be developed under both Pillar 1 (to ensure the robustness of the validated internal model for IRB banks) and Pillar 2. However, the Basel II framework lacked a clear set of recommendations for stress testing practices (e.g. scenario selection, risk coverage, integration in risk governance, IT infrastructure), leaving most of the choices to the banks' discretion. See Bevilacqua et al. (2019).

817 See Meissner (2016), p. 337.

818 See ECB (Jan 2020).

Following the detailed assessment by the JSTs, each of the four-aforementioned core SREP elements is given a specific SREP score ranging of '1' (low risk) to '4' (high risk). According to the ECB methodology[819], score '1' corresponds to 'strong control", i.e. there is no discernible risk of significant impact on the prudential elements of the group or its entities considering the management, organisation and controls. The level of risk management and control is high. The risk management and control framework is clearly defined and fully compatible with the nature and complexity of the institution's activities.

Score '2' corresponds to 'adequate control', i.e. there is a low risk of significant impact on the prudential elements of the group or its entities considering the management, organisation and controls. The level of risk management and control is acceptable. The risk management and control framework is adequately defined and sufficiently compatible with the nature and complexity of the institution's activities.

Score '3' corresponds to 'weak control', i.e. there is a medium risk of significant impact on the prudential elements of the group or its entities considering the management, organisation and controls. The level of risk management and control are weak and need improvement. The risks are insufficiently mitigated and controlled, leaving too high a residual risk. The risk management and control framework is poorly defined or insufficiently compatible with the nature and complexity of the institution's activities.

Score '4' corresponds to 'inadequate control', i.e. there is a high level of risk of significant impact on the prudential elements of the group or its entities considering the management, organisation and controls. The level of risk management and control is very low and needs drastic and/or immediate improvement. The risks are not or are inadequately mitigated and are poorly controlled. The risk management and control framework is not defined or not compatible with the nature and complexity of the institution's activities.

The holistic and forward-looking approach described above leads to an overall SREP assessment for each SI and the adoption by the ECB, through a supervisory decision, of quantitative capital measures, quantitative liquidity measures or qualitative supervisory measures[820], as appropriate. Accordingly, the overall SREP assessment determines the total SREP capital requirement ratio (**TSCR**), which is composed of Pillar 1 and Pillar 2 capital requirements. In particular, while supervisors should expect banks to operate above Pillar 1 minimum capital requirements, they assess through the SREP the risks that are not fully covered by the Pillar 1 capital requirements and buffers dictated by the CRR and CRD IV, and determine the quantity and composition of additional own funds required to cover such risks (Pillar 2). This additional capital should aim at covering unexpected losses, under-provisioned expected losses, as well as deficiencies in risk measurement models, governance and internal controls[821]. The sum of the TSCR combined with the capital conservation

[819] See ECB (Jan 2020).
[820] Qualitative supervisory measures would be drawn by the ECB from the catalogue under Article 16.2 SSMR. See Chapter 2, Paragraph 3.2.2.
[821] As specified by para. 344 of the SREP Guidelines, supervisors should only set additional own funds requirements to cover risks posed by control, governance and other deficiencies as an interim measure while the deficiencies are addressed.

buffer and the macroprudential buffers (excluding the so-called Pillar 2 Guidance[822]) is defined as overall capital requirement (**OCR**)[823].

3.4. The SREP decision

At the end of the assessment of the four core SREP elements, ECB staff from relevant ECB-SSM Divisions assigns an overall SREP score from '1' to '4' to each SI. In line with the SREP Guidelines, the overall SREP score represents a supervisory view of the overall viability of the institution on the basis of the aggregate view of the threats to such viability[824]. The overall SREP score should be assigned taking into account the outcomes of the assessment of individual risks, that is higher scores reflect an increased risk to the viability of the bank stemming from one or several features of its risk profile, including its business model, its internal governance framework, and individual risks to its solvency or liquidity positions.

Each JST can then adjust this anchoring overall SREP score by applying constrained judgement. Indeed, each JST has the possibility to modify the overall SREP score by -2/+1 notches, i.e. reduced by a maximum of two notches or improved by a maximum of one notch based on: i) their knowledge of the credit institution, ii) peer comparisons, iii) the macro environment under which the bank operates, iv) its capital/liquidity planning to ensure a sound trajectory towards the full implementation of prudential requirements, and v) the SSM risk tolerance[825]. In this sense, the JST may want to reflect in the overall SREP score weaknesses identified throughout the SREP process that it considers particularly important for the credit institution it directly supervises. The aim is to provide a holistic assessment of the institution's risk profile and assess the most appropriate supervisory measures, if needed: own funds requirements, liquidity requirements, or other qualitative supervisory measures.

The final SREP decision addressed to each SI is a supervisory decision in the meaning of Article 2 No (26) Framework Regulation (**FR**) and is adopted under the non-objection procedure[826]. Therefore, among others, it is issued following a hearing and it must be duly reasoned[827]. Also, it can be challenged before the CJEU. As mentioned, SREP decisions may include:

1) Own fund requirements[828]:
   - Total SREP capital requirement composed of Pillar 1 minimum own fund requirements and additional Pillar 2 own fund requirements (the '**Pillar 2 Requirements**', or '**P2R**');
   - Combined buffer requirement.
2) Institution-specific quantitative liquidity requirements:
   - LCR higher than the regulatory minimum;
   - Higher survival periods[829];

[822] See next Paragraph.
[823] See ECB (Jan 2020).
[824] EBA (Jul 2018), p. 31.
[825] See ECB (Jan 2020).
[826] Article 16 SSMR.
[827] See Chapter 2, Paragraph 4.1.
[828] EBA (Jul 2018), p. 131.
[829] The size of liquidity buffers should be determined according to the funding gap under stress conditions over defined time horizons, i.e. 'survival periods'. The definition of survival periods has been introduced by the CEBS in 2009 and it has been maintained by the EBA. See CEBS (2009).

- National liquidity measures[830].

3) Qualitative supervisory measures[831].

With regard to own funds requirement specifically, if the SREP assessment shows that the arrangements, strategies, processes and mechanisms implemented by the SI and the own funds held by it do not ensure a sound management and coverage of risks, the ECB may impose a Pillar 2 Requirement (P2R) and a Pillar 2 Guidance (P2G). The P2R is a binding requirement and must be met at all times by the relevant SI. As part of the Pillar 2 framework, qualitative outcomes of the EU-wide EBA stress test are taken into account in the determination of the P2R, especially for the element of risk governance. The quality of capital to be used to meet the P2R mirrors the composition of CRR Pillar 1 capital requirements (i.e. 56% CET1, 75% Tier 1 capital)[832]. The P2R is complemented by an additional capital layer, that is the non-binding Pillar 2 Guidance (**P2G**), which is primarily meant to incorporate the results of stress testing[833].

As second major component of the ECB-SSM Pillar 2, the P2G is usually specified by the ECB in the SREP supervisory decision and it is expressed as a full CET1 ratio add-on[834]. Accordingly, while the P2R can be met with capital reflecting the composition of Pillar 1 capital requirements, the P2G can be covered by CET1 capital only. Importantly, the capital used to meet P2R cannot be used to meet any of the CRD IV buffers[835]. The ECB sets P2G above the level of binding capital (minimum and additional) requirements and on top of the combined buffers. If a supervised entity does not meet its P2G, this will not result in automatic action by the supervisor and will not trigger any limitations on the maximum distributable amount (**MDA**)[836]. However, the ECB will more closely monitor institutions that do not meet their P2G and consider whether, and if so, which measures are to be taken to address the specific circumstances of the bank[837]. However, as the P2G is not a legally binding capital requirement, non-compliance with it by the supervised entity may not trigger the adoption by the ECB of supervisory measures under Article 16 SSMR (or, similarly, early intervention measures under Articles 27-29 BRRD[838]). Rather, in this case the supervisory action of the ECB-SSM shall take the form of supervisory dialogue and, possibly, informal action by the

[830] See Chapter 2, Paragraph 2.3.1.
[831] Additional supervisory measures stemming from Article 16.2 SSMR include, as an example, the restriction or limitation of business or operations, the requirement to apply a specific provisioning policy, the restriction of or prior approval to distribute dividends, or the imposition of additional or more frequent reporting obligations. For a discussion of the ECB-SSM supervisory powers, see Chapter 2, Paragraph 3.2.2.
[832] Article 104a (4) a CRD V. See Chapter 3, Paragraph II.
[833] The EBA defines the P2G as '*a non-legally binding capital expectation at level over and above overall capital requirements (OCR) based on the SREP findings, in particular: i) the ability to meet the applicable own funds requirements in stressed conditions, or (ii) supervisory concerns over the (excessive) sensitivity of an institution towards scenarios assumed in supervisory stress testing.*'. See EBA (Jul 2018), p. 147. In turn, Article 104b CRD V introduced, for the first time in EU supervisory law, specific rules on the P2G, which is defined under the CRD V as '*Guidance on additional own funds*'.
[834] When setting the P2G, different elements are taken into account by the ECB as part of its holistic approach. For instance, the starting point for setting the P2G is in general the depletion of capital in the hypothetical adverse scenario (quantitative outcome). Second, each JST takes into account the specific risk profile of the individual credit institution and its sensitivity to the stress scenarios. Interim changes in the bank's risk profile since the cut-off date of the EBA or ECB stress test and measures taken by the bank to mitigate risk sensitivities (such as relevant sale of assets) are considered. See ECB (Jan 2020).
[835] Article 104a (4) CRD V.
[836] Article 104b (6) CRD V. For a discussion of the MDA trigger, see Chapter 3, Paragraph 4.1.
[837] See ECB (Jan 2020).
[838] See Chapter 3, Paragraph 4.2.

relevant JST through operational acts[839]. In complex cases, in order to assess the final measures to be taken, the SB may assess the case of a bank not meeting its P2G and may take appropriate bank-specific action as deemed necessary.

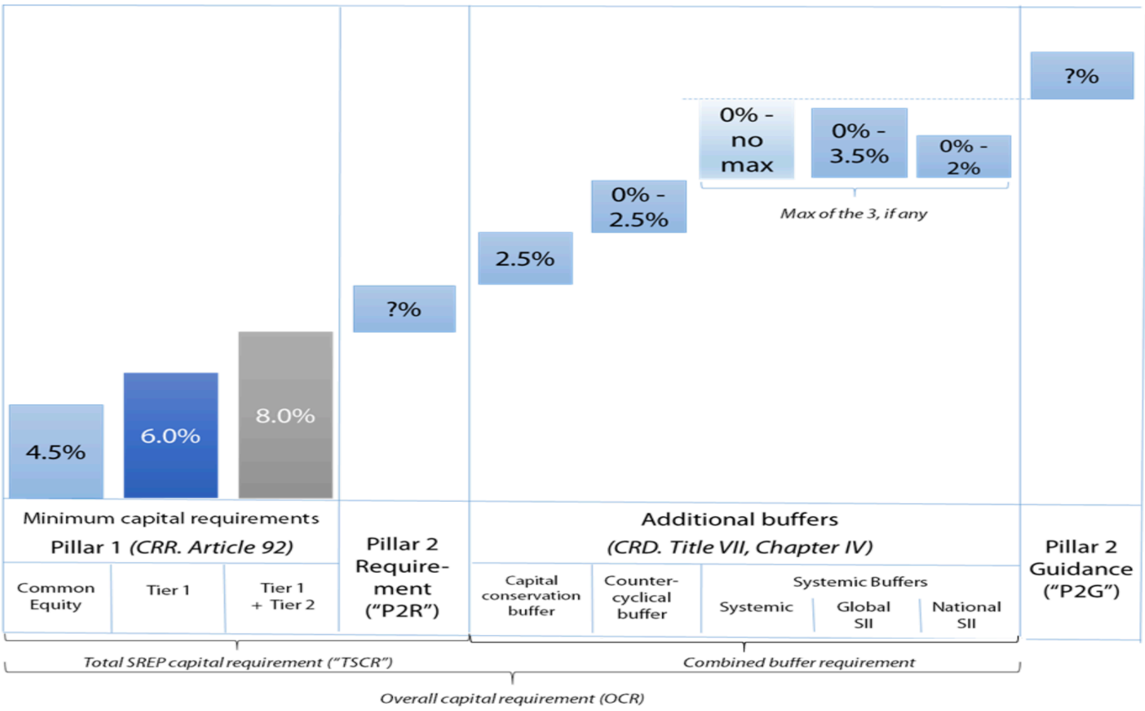

Figure 12. *Composition of the TSCR and OCR following the SREP.*
Source: Resti (2018).

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[839] See Chapter 2, Paragraph 1.2.

IV. Early Intervention Powers and Sanctioning Measures

4.1. The maximum distributable amount

In Chapter 3, we discussed the public administrative powers that, following the establishment of the SSM, have been entrusted to the ECB over the capital of Eurozone supervised entities both in terms of Pillar 1 and Pillar 2 requirements. In this regard, we analysed in detail, on the one hand, the terms and conditions that CRR eligible financial instruments must meet in order to be computed into banks' capital, the overall composition and stacking order of all the capital buffers that EU banks are required to meet at all times, and the first case-law developed by the CJEU in this area of European prudential law. On the other hand, we discussed the conditions under which credit institutions are allowed to reduce own funds and the ECB-SSM authorisation powers to enable banks to use IRB models to calculate minimum capital requirements as a ratio to RWAs. Against this backdrop, Chapter III, Paragraph IV. deals with the early intervention powers and sanctioning measures at disposal of the ECB-SSM in case supervised entities were to breach the prescribed prudential requirements in the area of own funds and use of internal models.

The first type of supervisory measure, of quasi-sanctioning nature, is embedded into Article 141.1 CRD IV, which prevents credit institutions from making distributions in connection with CET1 capital to an extent that such distributions would decrease their CET1 capital to a level where the Pillar 1 capital requirements and the combined buffer requirement is no longer met. According to Article 141.2 to Article 141.6 CRD IV, banks that fail to meet the Pillar 1 and the combined buffer requirement are required to calculate the maximum distributable amount (**MDA**) and are prohibited, before the calculation of the MDA, from i) making a distribution in connection with CET1 capital[840], ii) creating an obligation to pay variable remuneration or discretionary pension benefits or pay variable remuneration if the obligation to pay was created at a time when the institution failed to meet the combined buffer requirements, and iii) making payments on AT1 instruments[841]. In substance, by establishing an MDA, Union supervisory law brings a limitation to the distribution of earnings by financial institutions, i.e. a limitation to the shareholders and bondholders' rights to receive dividends, AT1 coupons or variable remuneration by their debtor bank that is non-compliant with EU capital requirements. In particular, Article 141.4 CRD IV provides that the MDA is calculated by multiplying the sum of interim year-end profits not yet included in CET1 by the factor (0, 0.2, 0.4 or 0.6) determined in accordance with Article 141.6 CRD IV. The factor is determined by a quartile of the combined buffer requirement, considering the CET1 capital of the credit institution that is not used to meet '*the own funds requirements under Article 92(1)(c) of Regulation (EU) No 575/2013*' (i.e.

[840] According to Article 141.10 CRD IV, a distribution in connection with CET1 capital shall include the following: i) a payment of cash dividends, ii) a distribution of fully or partly paid bonus shares or other capital instruments that are classified as CET1 capital instruments under Article 26.1 CRR (see Chapter 3, Paragraph 2.1.), iii) a redemption or purchase by a credit institution of its own shares or other capital instruments that are classified as CET1 capital instruments under Article 26.1 CRR, iv) a repayment of amounts paid up in connection with capital instruments that are classified as CET1 capital instruments under Article 26.1 CRR, and v) a distribution of CET1 items (excluding ordinary shares).

[841] Article 141.2 CRD IV.

Pillar 1 capital requirements)[842]. Importantly, Article 141 (a) CRD V clarified that a bank shall be considered as failing to meet the combined buffer requirement for the purposes of Article 141.1 CRD IV where it does not have own funds in an amount and of the quality needed to meet at the same time the i) Pillar 1 capital requirements, ii) the combined buffer requirement, as well as iii) '*the additional own funds requirement addressing risks other than the risk of excessive leverage under point (a) of Article 104(1) of this Directive*' (i.e. Pillar 2 capital requirements)[843].

As timely and full capital restoration is precisely what is pursued by the calculation of the MDA under Article 141.6 CRD IV, where a bank fails to meet in full its combined buffer requirement, it should be subject to measures designed to ensure that it restores its levels of own funds in a timely manner[844]. This objective of capital conservation is particularly achieved by the capital conservation plan under Article 142 CRD IV[845]. According to this provision, where a bank fails to meet its combined buffer requirement, it shall prepare a capital conservation plan and submit it to the competent supervisory authority (i.e. the ECB within the EBU) no later than five working days after it identified that it was failing to meet that requirement (unless the competent supervisory authority authorises a longer delay up to 10 days)[846].

The capital conservation plan shall include the following: i) estimates of income and expenditure and a forecast balance sheet, ii) measures to increase the capital ratios, iii) a plan and timeframe for the increase of own funds with the objective of meeting fully the combined buffer requirement, and iv) any other information that may be necessary to the ECB. In turn, the ECB shall assess the capital

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[842] The effect of Article 141.5 CRD IV is that, when the sum of interim or year-end profits not yet included in CET1 is zero, any breach of the combined buffers will entail an MDA of zero no matter how much CET1 capital the institution holds in excess of its Pillar 1 capital requirement.

[843] The inclusion of Pillar 2 capital requirements in the calculation of the MDA threshold has been an appropriate regulatory clarification brought forward by the CRD V, as the previous supervisory framework laid down by Article 141 CRD IV seemed to exclude – in a rather incoherent fashion, in our view – Pillar 2 capital requirements from the MDA trigger calculations. However, the EBA followed a different approach under the CRD IV framework. Indeed, in its 2015 *Opinion on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions*, the EBA favoured a teleological, extensive interpretation of Article 141 CRD IV and set out that it expected competent authorities and banks to calculate the MDA factor with the CET1 capital held in excess of CET1 capital held to meet both Pillar 1 *and* 2 capital requirements (i.e. the EBA discouraged what is called the 'Danish approach', that is Pillar 2 was not included in the MDA computation). While this view was consistent with the ultimate goal of safeguarding financial stability and the policy objectives of the different capital requirements, such interpretation of Article 141 CRD IV might have seen as an alteration of EU primary law by a European agency, which had not been mandated to do so. Furthermore, the EBA's position might have been against the European Convention on Human Rights (**ECHR**) as receiving a share of the net profit of a company in proportion to the equity participation is a basic property right of shareholders covered by the ECHR. The legal principle that provisions which restrict the free exercise of property rights must be interpreted narrowly is largely used by the European Court of Human Rights about the limitations to such rights enshrined in the ECHR. Under this perspective, the regulatory changes brought forward by Article 141 (a) CRD V can be considered well-timed as they clarified a technical issue that – if unaddressed – would have most certainly caused legal misinterpretations and the institution of multiple legal proceedings before European Courts. For the EBA Opinion on the calculations of the MDA trigger, see EBA (2015).

[844] Recital 89 CRD IV reads: '*Where a credit institution or investment firm fails to meet in full the combined buffer requirement, it should be subject to measures designed to ensure that it restores its levels of own funds in a timely manner. In order to conserve capital, it is appropriate to impose proportionate restrictions on discretionary distributions of profits, including dividend payments and payments of variable remuneration. So as to ensure that such institutions or firms have a credible strategy to restore levels of own funds, they should be required to draw up and agree with the competent authorities a capital conservation plan that sets out how the restrictions on distributions will be applied and other measures that the institution or firm intends to take to ensure compliance with the full buffer requirements.*'.

[845] This power is directly available to the ECB under Article 16.2 (c) SSMR.

[846] The ECB-SSM shall grant such authorisations only on the basis of the individual situation of a credit institution and taking into account the scale and complexity of the institution's activities. See Article 142.1, second indent, CRD IV.

conservation plan, and shall approve the plan only if it considers that the plan, if implemented, would be reasonably likely to conserve or raise sufficient capital to enable the supervised entity to meet its combined buffer requirement within a period the ECB considers appropriate. Should the ECB not approve the capital conservation plan, it shall take appropriate supervisory measures under Article 16.2 SSMR, that is, *inter alia*, it shall require the relevant SI to increase own funds to specified levels within specified periods, and it shall exercise its powers to impose more stringent restrictions under Article 16.2 SSMR on distributions than those required by Article 141 CRD IV.

4.2. Early intervention powers

The entry into force of the BRRD in 2015 established the new crisis management framework in the EU. In line with the FSB Key Attributes[847], the BRRD introduced recovery and resolution planning, as well as gave specific tools and powers to national resolution authorities (**NRAs**)[848] allowing for failing institutions to be resolved instead of applying normal insolvency procedures[849]. In addition, the BRRD introduced early intervention measures (**EIMs**), which were added to the supervisory powers already established by Article 104 CRD IV, Article 16 SSMR (which largely mirrors the CRD IV) or national law[850]. Early intervention constitutes one of the three pillars of the

[847] See Chapter 1, Paragraph 3.2.

[848] In line with the international framework developed by the FSB and the IMF, Article 3 BRRD calls each EU Member States for the establishment of a resolution authority in charge of i) planning crisis management, ii) intervening in time to prevent a full-blown crisis, and iii) handling the 'resolution' stage in the best possible way through appropriate 'resolution' tools. As part of the EBU project, in 2013 the EC put forward a legislative proposal, then endorsed in 2014 by European co-legislators, to establish a harmonised and effective resolution regime for Eurozone banks (i.e. the second pillar of the EBU). This policy objective, which required, as much as the SSM, the set-up of common supranational governance and institutional arrangements, has been achieved through the approval of Regulation (EU) No 806/2014 of 15 July 2014 (the '**SRMR**') which established the Single Resolution Mechanism (**SRM**) and a common resolution authority (in the form of a European agency) for Eurozone Member States, i.e. the Single Resolution Board (**SRB**). The SRM aims to create a more uniform and harmonised resolution process and application of substantive rules across the Eurozone that can more effectively place banks experiencing solvency problems into resolution with no costs to taxpayers and the broader economy. In this sense, while the BRRD that lays down the EU-wide substantive rules pertaining to the resolution of designated entities and groups, the SRMR mainly contains rules on the procedure for resolution planning with regard to early intervention and resolution of such entities and groups by the SRB or NRAs within the EBU. As such, the SRM and the SRB apply the substantive rules of the BRRD/SRMR to banks that are supervised by the ECB-SSM, as the objective scope (i.e. the EBU jurisdictions) and subjective scope (i.e. the significant banks) of the two Mechanisms remain the same, but the SRB is also in charge of taking resolution action as regards cross-border banking groups that are not classified as significant (as of 1 November 2020, seven in the entire Eurozone). The SRM is supported by the Single Resolution Fund (**SRF**), which is managed by the SRB. The SRF's primary function is to finance resolution measures, by granting loans or guarantees on claims to the ailing bank. Additionally, if some claims have to be excluded under the circumstances specified in the BRRD – to prevent contagion, for example – within certain limits, the SRF may absorb losses in place of the excluded creditors, reducing the size of the bail-in. The SRF shall be financed by contributions from Euro area banks and progressively mutualised by end-2024 pursuant to an inter-governmental agreement. For an analysis of the SRM and the SRB, see Kern (2015); Wymeersh (2015).

[849] Early intervention constitutes a key component of supervisory action and is defined by the BCBS '*Core Principles for Effective Banking Supervision*' in the following way: '*adopting a forward-looking approach to supervision through early intervention can prevent an identified weakness from developing into a threat to safety and soundness. This is particularly true for highly complex and bank-specific issues (e.g. liquidity risk) where effective supervisory actions must be tailored to a bank's individual circumstances.*'. See BCBS (Sep 2012), para. 13.

[850] As the CRD creates only minimum harmonisation, some EU Me

mber States have assigned to the competent authorities additional measures to complement the Union-wide toolkit. In light of Article 9.1 (3) SSMR, such measures can be applied also by the ECB, by way of binding instructions, both based on ongoing supervision and as a part of early intervention.

BRRD, which are i) preparation (i.e. recovery and resolution planning)[851], ii) early intervention[852], and iii) resolution[853]. In particular, the new EU-wide BRRD regulatory framework for recovery and resolution[854], applicable from 1 January 2015, requested Member States to put at disposal of their NCAs an additional set of EIMs, without prejudice to measures referred to Article 104 CRD IV. The objective was to increase the toolkit available to competent supervisory authorities to handle crises in ailing credit institutions. These measures are listed under Article 27.1 BRRD and must be available for competent authorities in cases where an institution infringes, or is likely in the near future to infringe, the prudential requirements of the CRD package, Title II of Directive 2014/65/EU (the '**MiFID II**')[855] or certain Articles of Regulation (EU) No 600/2014[856] (the '**MiFIR**'), as well as the relevant national implementing legislation. In such cases, the institution meets the conditions for early intervention[857].

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[851] Articles 4-26 BRRD.

[852] Articles 27-30 BRRD.

[853] Articles 31-86 BRRD.

[854] The EU recovery and resolution framework largely mirrors the international FSB framework. For a comprehensive overview of the BRRD at EU level, see, among others, World Bank Group (Apr 2017); Gortsos (2015).

[855] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU. Following the outbreak of the GFC, which had one of its main causes deeply rooted in the lack of transparency of collateral debt obligations and securitised financial instruments, EU regulators, in line with IOSCO recommendations, approved the MiFID II, which arose from an amendment and restatement of MiFID I, and was accompanied by the MiFIR. At its core, MiFID II focused on ensuring greater investor protection, market transparency and more explicit regulations around derivative products. Accordingly, MiFID II strived to introduce a more integrated market environment in the EU by requiring financial services firms to have appropriate governance and risk management arrangements ready to achieve best possible outcomes for their clients. The MiFID II was primarily formulated to produce a new transparency landscape serving to protect the buy-side irrespective of the location of trade execution within the EU. On the MiFID II-MiFIR 'revolution', see, among others, Yeoh (2019). On the broader European Capital Markets Union (**CMU**) project, see Bush, Avgouleas and Ferrarini, eds., (2018).

[856] Specifically, Articles 3 to 7, 14 to 17, and 24, 25 and 26 of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

[857] Pursuant to Article 27.4 BRRD, in 2015 the EBA published Guidelines addressed to competent authorities and aimed at promoting the consistent application of triggers for the decision on the application of early intervention measures set out in Article 27.1 BRRD (the '**early intervention Guidelines**'). The EBA Guidelines identify triggers within the common European SREP framework and elaborate on the circumstances prompting the consideration of whether to apply early intervention measures. In particular, the triggers are based on the scores supporting the outcomes of the assessment of the various core SREP elements and the overall SREP assessment indicating any threat to the viability of an institution and whether an institution infringes or may infringe requirements of EU legislation (first and foremost, the CRD package) and national implementing legislation. In addition, the EBA early intervention Guidelines lay out the possibility for NCAs to make use of the EIMs on the basis of other circumstances which may not be immediately factored into the outcomes of the SREP assessment. In this regard, EIMs can be triggered by i) a material change or anomalies identified in the monitoring of key indicators performed as part of SREP, even before the assessment of the respective SREP element is updated, and ii) by events of significant importance (so-called significant events) that carry a risk of having a significant, prudential impact on the bank. If the NCAs (as the ECB did) decided to comply with the EBA early intervention Guidelines, such NCAs have the obligation to consider and make a decision on whether to apply the EIMs under any of the three situations mentioned above, if certain triggers are met. In particular, with regard to triggers based on the outcomes of the SREP, EIMs should be considered in case a bank is assigned the overall SREP score of '4' or SREP score of '3' in combination with '4' in the sub-categories of capital, liquidity, business model or governance (see para. 12 ff. EBA early intervention Guidelines). With reference to the material changes or anomalies criterion, where a bank's financial condition and risk outlook and SREP score for a particular element (e.g. capital ratios) deteriorate significantly and impact one of the triggers based on the combination of the overall SREP score and scores for individual SREP elements, NCAs should take a decision on whether to apply EIMs (see para. 21 EBA early intervention Guidelines). Last, according to para. 23 EBA early intervention Guidelines, certain events may have a significant impact on an institution's financial conditions, putting it into a situation where conditions for early intervention are met relatively rapidly. Such events may be, for instance, major operational risk events (e.g. rogue trading, fraud, natural disaster, severe IT problems, significant fines imposed on the bank by public authorities), a significant deterioration in the amount of the MREL or a

Article 27.1 BRRD enlists the following EIMs[858]:

1) require the management body of the bank to implement one or more of the arrangements or measures set out in the recovery plan or, in accordance with Article 5.2 BRRD, to update such recovery plan when the circumstances that led to the early intervention are different from the assumptions set out in the initial recovery plan, and implement one or more of the arrangements or measures set out in the updated plan within a specific timeframe;
2) require the management body of the credit institution to examine the situation, identify measures to overcome any problems identified and draw up an action programme to overcome those problems and a timetable for its implementation;
3) require the management body of the bank to convene, or if the management body fails to comply with that requirement convene directly, a meeting of shareholders of the institution, and in both cases set the agenda and require certain decisions to be considered for adoption by the shareholders;
4) require one or more members of the management body or senior management to be removed or replaced if those persons are found unfit to perform their duties pursuant to Article 91 CRD IV;
5) require the management body of the institution to draw up a plan for negotiation on restructuring of debt with some or all of its creditors according to the recovery plan, where applicable;
6) require changes to the institution's business strategy;
7) require changes to the legal or operational structures of the institution; and
8) acquire, including through on-site inspections and provide to the resolution authority, all the information necessary in order to update the resolution plan and prepare for the possible resolution of the institution and for valuation of the assets and liabilities of the institution in accordance with Article 36 BRRD.

As discussed in Chapter 2[859], the majority of the aforementioned early intervention measures cannot be differentiated from Union law supervisory measures, due to the fact that, as also noted by the EBA, Article 27 BRRD largely overlaps with the ECB supervisory powers set out under Article 104 CRD IV and Article 16 SSMR[860]. As a consequence, it has been argued that the nature of BRRD early intervention measures is, in fact, the one of supervisory measures[861]. In this regard, it is worth mentioning that over the first four years since the BRRD entry into force, the EBA has observed '*a limited application*' of the EIMs across the EU[862]. In 2019, the EBA has conducted among NCAs a survey according to a pre-defined questionnaire to examine the application of EIMs across the EU.

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significant outflow of funds, including retail deposits of customers, caused, e.g. by the reputational damage of the institution. See EBA, *Guidelines on triggers for use of early intervention measures pursuant to Article 27(4) of Directive 2014/59/EU*, EBA/GL/2015/03, 8 May 2015.

858 The EIMs specified in Article 27.1 BRRD are complemented with additional measures, which are *stricto sensu* not EIMs, namely the removal of senior management and management body (Article 28 BRRD) and the appointment of a temporary administrator (Article 29 BRRD). Thus, under the current framework, different level of severity exists within the EIMs, because in principle the measures listed in Articles 28-29, should be implemented only if the measures from Article 27.1 and Article 28, receptively, are not sufficient to reverse the deterioration. See EBA (Jun 2020).

859 See Chapter 2, Paragraph 3.1.6.

860 See EBA (Jun 2020), p. 27.

861 See Lackhoff (2017), p. 205.

862 See EBA (Jun 2020), p. 7.

Since the entry into force of the BRRD, only nine EU NCAs have applied EIMs. Among the nine competent authorities that have used this tool, the total number of EIMs[863] applied was also very small. The highest number of EIMs applied in one Member State since 2014 was twelve, while in all remaining eight jurisdictions the reported number of EIMs imposed was lower, with only two EIMs being applied in four jurisdictions[864]. Moreover, it is important to note that in almost half of the EU jurisdictions competent authorities decided not to apply EIMs in cases when early intervention conditions were met, and instead used other supervisory powers available to them (for instance, measures based on Article 104 CRD IV)[865]. In light of the above, we believe that, in the context of the upcoming CRD VI package review, the categorisation between CRD supervisory measures and BRRD early intervention measures could be substituted from the application of the principle of proportionality, that is more severe measures, such as the removal of board members, would require a more deteriorated financial situation in the credit institution.

4.3. Sanctioning powers

Sanctions, i.e. any reaction to an infringement of a rule, are intimately connected to any legal system. According to some doctrine, the existence of a sanction as a reaction to the infringement of a provisions is the main criterion to consider that provision as 'legal'[866]. Traditionally, the power to impose (criminal) sanctions was reserved to the judiciary. The power to impose (administrative) sanctions has been increasingly extended, in all legal systems, to the administration. The existence of a common 'punitive' ratio underlying the two categories of sanctions is somehow mirrored by the application of a common regime in the context of the ECHR[867]. The Treaties have not conferred to the EU a general competence to impose criminal sanctions, while the power to impose administrative sanctions has been conferred to the EU in specific fields by acts of secondary EU law. The ECB was conferred instead the power to impose sanctions since its inception, and on the basis of a provision of primary law[868]. According to Article 34.3 ESCB statute, the ECB could impose fines or periodic penalty payments (jointly referred to as '**sanctions**') in case of non-compliance with its regulations and decisions, within the limits and the conditions adopted by the Council. Such limits and conditions are contained in Council Regulation (EC) No 2532/98[869] (**Council Regulation 2532/98**), as further implemented by a specific ECB Regulation[870].

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[863] Including EIMs listed in Article 27.1 BRRD as well as the appointment of a temporary administrator according to Article 29 BRRD.

[864] The number of cases reported for the EU Member States from the Eurozone relates only to LSIs established in these jurisdictions, whereas the number of cases notified by the ECB relates to significant institutions under its supervision.

[865] An overview of the application of specific EIMs from Article 27.1 BRRD by EU NCAs is provided under figure No 7, EBA (Jun 2020), p. 21.

[866] See Riso (2014).

[867] See next Paragraph. On the application of the principles enshrined in the ECHR to the EU legal order, see Articles 50 and 53 of the Charter of Fundamental Rights of the European Union (the '**Charter**').

[868] See Article 34.3 of the ESCB statute. Regarding the ECB power to impose regulatory sanctions, see Martin and Texeira (2000).

[869] Council Regulation (EC) No 2532/98 of 23 November 1998 concerning the powers of the European Central Bank to impose sanctions.

[870] European Central Bank Regulation (EC) No 2157/1999 of 23 September 1999 on the powers of the European Central Bank to impose sanctions (ECB/1999/4).

In the context of the SSM, the power of the ECB to impose sanctions has been extended beyond the cases of infringement of ECB regulations and decisions[871]. Hence, Regulation 2532/98 gains limited relevance within the SSM framework. On the other hand, the cornerstone of the ECB-SSM sanctioning supervisory regime is Article 18 SSMR, which attributes the power to impose administrative pecuniary penalties directly to the ECB[872]. While Article 18 SSMR does not expressly distinguish the potential addressees of the ECB sanctioning power on the basis of their significance, the application of the SSMR significance criteria has to be upheld as it ensures consistency with the overall organisation of the SSM pursuant to Article 6 SSMR[873]. Therefore, the 'significance criterion' applies in respect of Article 18.1 SSMR, according to which the ECB may impose administrative pecuniary penalties on significant supervised entities for breaches of prudential requirements under directly applicable acts of Union law (such as the CRR) in relation to which administrative pecuniary penalties are available. Therefore, the ECB, under Article 18.1 SSMR, cannot sanction natural persons[874] or supervised entities for any breach of a CRD IV provision. According to Article 18.4 SSMR, administrative pecuniary penalties pursuant to Article 18.1 SSMR shall be applied in accordance with the procedures laid down by Council Regulation 2532/98[875].

For sanctioning proceedings pursuant to Article 18.1 SSMR, Articles 123 to 128 FR provide for a specific sanctioning procedure that partly derogates to the general procedural rules applying to ECB supervisory procedures[876]. The cornerstone of this regime is that the investigation of an alleged breach in the meaning of Article 124 FR shall be carried out by an independent investigating unit. The internal independent investigating unit (**IIIU**) is created ad-hoc on a case by case basis and is composed by officers of the Enforcement and Sanctions Division of the DG SSM Governance and Operations (**DG/SGO**)[877]. The purpose of the IIIU is to separate ECB-SSM staff dealing with administrative penalties from staff and structures carrying out ongoing supervision[878]. To this end, the IIIU shall perform its investigative functions independent from the supervisory activities of the SSM[879] but may, nevertheless, require the JST to support it by providing information. In order to initiate the process, JSTs are obliged to refer by a referral report any (potential) breach of directly applicable Union law, including ECB regulations and decisions[880], to the IIIU, i.e. in fact the Enforcement and Sanctions Division within DG/SGO. In order to assess the breach, the IIIU is

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871 On the ECB-SSM power to impose administrative pecuniary sanctions on supervised entities, see Gortsos (2015); Riso (2014).
872 Article 18 SSMR must be read in conjunction with the CRD IV and the FR. In particular, as a general principle, the CRD IV requires that effective, proportionate and dissuasive administrative penalties and other measures are imposed in respect of national provisions transposing the CRD IV and of the CRR, including in particular administrative pecuniary penalties. See Article 65.1, and Articles 66(2)(c) to (e) and 67(2)(e) to (g) CRD IV.
873 In these terms, see Lackhoff (2017); Riso (2014). See Chapter 2, Paragraph 1.2.
874 This is further confirmed by Article 124 (a) FR.
875 The procedural provision in Article 3 Council Regulation 2532/98 provides, among others, for the decision on sanctions to be taken by the EB and for the GovC to be competent for the review of such decisions and does not provide for the involvement of the SB. Taking into account the central role of the SB in the decision-making process as regards supervisory matters, Article 3 Council Regulation 2532/98 does not seem to be compatible with the SSMR. Consequently, the procedural rules for the adoption of measures based on Article 18.1 SSMR are only those laid down in the FR based on Article 4.3 SSMR, as also confirmed by Article 121.1 FR. See Lackhoff (2017), p. 215.
876 Article 2 No (24) FR. See Chapter 2, Paragraph IV.
877 See Chapter 2, Paragraph 1.1.
878 See Lackhoff (2017), p. 215.
879 Article 123.3 FR.
880 Article 124 (b) FR.

entrusted with the investigatory powers conferred to the ECB by the SSMR[881]. After the completion of its investigation, the IIIU shall notify the supervised entity in writing of its findings and any objections (statement of objections). The hearing shall relate to the facts, the objections and the individual provisions which have been allegedly infringed[882]. At this point, the sanctioning procedure concludes with the adoption (or not) of a supervisory sanctioning decision by the SB and the GovC under the non-objection procedure[883].

The maximum amount of the administrative pecuniary penalties which the ECB may impose is defined instead directly in Article 18.1 SSMR, in line with CRD IV, as i) '*twice the amount of the profits gained or losses avoided because of the breach where those can be determined*', or ii) '*10% of the total annual turnover of a legal person in the preceding business year*', or such other pecuniary penalties as may be provided for in relevant Union law[884]. Pursuant to Articles 18.2 SSMR and Article 128 FR, the relevant turnover is defined as the total turnover resulting from the consolidated financial accounts of the ultimate parent undertaking in the preceding business year. In determining within the given time frame the specific administrative pecuniary penalty, the ECB has to take into account the entire facts of the case. The criteria mentioned in Article 2 Council Regulation 2532/98 indicate circumstances which the ECB has to take into account. The ECB may keep the proceeds from administrative pecuniary sanctions[885]. According to Article 132 FR, the ECB will publish without undue delay, and maintain for five years on its website, any administrative pecuniary penalty it may impose, '*whether it has been appealed or not*'[886]. The publication shall include information of the type and nature of the breach and the identity of the supervised entity. If an ECB decision imposing administrative pecuniary penalties is contested, the ECB shall also publish information on the status of the proceeding[887].

Article 18.5 SSMR complements Article 18.1 SSMR and, at the same time, limits the power of the ECB to impose administrative penalties. It complements Article 18.1 SSMR by stipulating that the ECB may instruct the relevant NCA to open proceedings with a view to ensure that appropriate administrative penalties are imposed in cases not covered by Article 18.1 SSMR. It limits the power of the ECB as the ECB may require NCAs to open proceedings with a view to taking action in order to ensure that appropriate administrative penalties are imposed in accordance with Union law. Therefore, the ECB has not direct influence on the sanctioning proceeding and its outcome. Rather, the ECB may (only) in its role as 'supervisor of supervisors' review whether the sanctioning proceeding by the NCA is effective, proportionate and dissuasive[888]. The ECB may require to open a sanctioning proceeding i) in light of the nature of the infringement, i.e. when there is a breach of national law transposing relevant Directives or conferring specific powers which are currently not

[881] For an analysis of the ECB investigatory powers, see Chapter 2, Paragraph 2.2.
[882] Article 126.2 FR.
[883] See Chapter 2, Paragraph IV.
[884] This latter provision is a placeholder and is meant to leave the door open to possible future developments in the sanctioning regulatory regime under the CRD IV.
[885] Article 137 FR.
[886] Article 132.1 (a) and (b) FR provide for some exceptions when the plain publication of the decision would either jeopardise the stability of the financial markets or an on-going criminal investigation, or cause disproportionate damage to the supervised entity concerned. In both cases, an assessment will need to be conducted case by case by the ECB.
[887] Article 132.3 FR.
[888] Article 134 FR. On the other hand, in the cases under Article 18.5 SSMR, the NCAs do not have the possibility to start sanctioning proceedings in the absence of a request of the ECB.

required by Union law, or ii) in case the addressee of the sanctioning measure is a natural person (e.g. a member of the management body of the relevant SI). In this sense, Article 18.5 SSMR partially derogates to the allocation of sanctioning competences according to the significance criterion under Article 6 SSMR.

Additionally, the application of the significance criterion is subject to specific derogations also under Article 18.7 SSMR. By way of derogation, the ECB may impose sanctions also on LSIs in case of case of a breach of ECB regulations or decisions (addressed to those entities). Such interpretation of Article 18.7 SSMR is in particular confirmed by Article 122(b) FR. The aim of this provision is to ensure that the ECB is capable of enforcing rules originating from its own legal acts. Pursuant to Article 18.7 SSMR, the ECB may impose sanctions in accordance with Council Regulation 2532/98. For procedures directed to the imposition of fines it can be derived from Article 4b Council Regulation 2532/98 that the investigation is carried out in the same manner as in the case of the ECB making use of Article 18.1 SSMR. This approach is also supported by Article 124 and Article 121.2 FR. In case of a procedure directed to the issue of periodic penalty payments, the procedural rules of Article 22 SSMR and Articles 25 to 35 FR shall apply. Accordingly, the procedure for the adoption of periodic penalty payments follows the procedure for the adoption of ECB supervisory procedures. In particular, no IIIU is set-up[889].

4.4. The determination of failing or likely to fail

In case the imposition of supervisory measures under Article 104 CRD IV and Article 16 SSMR[890], early intervention powers under Articles 27-29 BRRD[891], and administrative pecuniary penalties under Article 18 SSMR[892] would not satisfy the ECB that a certain supervised entity has returned to compliance with prudential requirements, that institution may eventually be declared failing or likely to fail (**FOLTF**). As of 1 January 2016, the FOLTF declaration can be issued by both the ECB and the SRB within the EBU. In accordance with Article 18.1 and 18.4 SRMR, the ECB shall consult with the SRB before it takes a FOLTF decision. Following the FOLTF declaration by the ECB, the SRB may decide to start a resolution action if i) no alternative private sector or supervisory remedial measures are available and ii) a resolution action is necessary in the public interest[893]. According to Article 18.1 SRMR, the SRB can assess the FOLTF only after informing the ECB of its intention and only if the ECB within three calendar days does not make such an assessment.

As a rule, a supervised entity shall be considered FOLTF in one or more of the following situations[894]:

a) a bank infringes - or will in the near future infringe - the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation[895];
b) a bank's assets are - or will be in the near future - less than liabilities (i.e. over-indebtedness);

[889] See Lackhoff (2017), p. 220.
[890] See Chapter 2, Paragraph 3.2.
[891] See Chapter 3, Paragraph 4.2.
[892] See Chapter 3, Paragraph 4.3.
[893] Article 32.1 BRRD and Article 18.1 SRMR.
[894] Article 32.4 BRRD and Article 18.4 SRMR.
[895] See Chapter 2, Paragraph 2.1.2.

c) a bank is unable – or will be so in the near future – to pay debts or other liabilities as they fall due (i.e. illiquidity);
d) extraordinary public financial support is required (state aid) with certain exceptions.

In cases a) to c) this definition differentiates i) situations in which an infringement, over-indebtedness or illiquidity already occurred, and ii) situations where based on objective elements it is expected that such circumstances will occur within the near future. The BRRD does not provide a definition of what is '*near future*', thus leaving to the ECB[896] to select the most appropriate time horizon given the objectives of the relevant assessment and considering all relevant circumstances. As the nature and pace at which crises evolve is not uniform, it would be difficult, and possibly counter-productive, for the ECB to pre-commit to a specific time-horizon for defining positively what '*near future*' is; however, events happening in a time horizon beyond one year could generally be considered as not covered by '*near future*'[897].

In accordance with its mandate to promoting convergence of supervisory and resolution practices and fostering the EU 'single rulebook' for banking services, the EBA published Guidelines on the circumstances under which a credit institution shall be considered as FOLTF (triggers for resolution) in order to ensure continuum between the on-going supervision conducted by NCAs under the CRD package and the BRRD (the '**EBA Guidelines on FOLTF**')[898]. The EBA Guidelines on FOLTF further specify Article 32.4 (a), (b) and (c) BRRD and provide a non-exhaustive list of objective elements on the basis of which the NCAs/NRAs' expert judgement on FOLTF should be based. The capital and liquidity position and other requirements for continuing authorisation, including governance arrangements and operational capacity are mentioned as such objective elements. Those elements are non-exhaustive and will usually be assessed within the performance of the SREP[899]. The EBA Guidelines on FOLTF suggest to base the FOLTF determination on i) a SREP score of 'F', or ii) a score of '4' combined with a failure to comply with supervisory measures under Articles 104 and 105 CRD IV (i.e. Article 16 SSMR within the Banking Union) or early intervention measures under Article 27.1 BRRD[900]. Although also the breach or likely breach of any other requirements for continuing authorisation including governance arrangements and operational capacity can be considered in triggering the FOLTF determination, the infringements of capital and liquidity requirements are the most likely issue when it comes to assessing the FOLTF. In particular, for the determination of FOLTF, the ECB-SSM needs to positively assess i) the existence of a non-

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[896] As well as the relevant NRA for LSIs, if provided for by the legislation of the Member State.

[897] Given that Article 102.1 (b) CRD IV explicitly provides for a one-year time horizon for likely breaches to be covered by the supervisory measures under Article 104 CRD IV, this time horizon could possibly be considered as a baseline. However, if specific circumstances require so, the ECB may depart for the purpose of the FOLTF assessment under Article 32 BRRD (and, also, early intervention under Article 27 BRRD).

[898] EBA, *Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*, EBA/GL/2015/07, 26 May 2015. As the conditions for triggering the resolution of a bank have been harmonised, it would appear reasonable to consider harmonisation of the triggers for insolvency proceedings of banks that are declared failing, but where resolution measures are not in the public interest. See Chapter 4, Paragraph II., for a more detailed discussion of this issue.

[899] See Chapter 3, Paragraph III.

[900] As for the detailed objective elements relating to capital and liquidity, see para. 19 ff., and para. 23 ff., of the EBA Guidelines on FOLTF assessment. For the process of determining that an institution is FOLTF, see Title III, para. 31 of the EBA Guidelines on FOLTF assessment. In the assessment of the core SREP elements, competent authorities should assign a score of '4' to reflect the worst possible assessment; a score F is the negative grade to be used for the overall SREP assessment for institutions that the competent authority has determined to be FOLTF.

temporary breach or likely breach of capital or liquidity requirements for continuing authorisation, and ii) that it is proportionate to determine the credit institution FOLTF in light of such breach or likely breach.

4.4.1. Breach, or likely breach, of capital (and liquidity) requirements

On the whole, each breach of Pillar 1 capital requirements (as defined under Article 92 CRR[901]) or Pillar 2 capital requirements (as defined in Article 104.1 (a) CRD IV[902]) can provide a basis for considering a FOLTF assessment. Therefore, a breach would consist of an institution not meeting the requirements of CET1 (4,5%), Tier 1 capital ratio of 6% and total capital ratio of 8%, as well as the 2,5% CET1 capital conservation buffer and/or the additional requirement to hold own funds in excess by the ECB. However, it is suggested that the breach of Pillar 2 capital requirements should be considered carefully in transition periods, where the required CET1 capital requirements include the Pillar 2 and capital conservation buffer requirement. On the other hand, it can be argued that a breach of the CET1 capital requirements that merely affects the countercyclical buffer and/or the G-SIB/O-SIB requirement would not justify the FOLTF determination, as such buffers, among others, are meant to absorb first capital shortfalls in case of financial stress. However, in such a case, the relevant bank would need to prepare promptly a capital conservation plan in accordance with Article 141 CRD IV[903] and submit it to the ECB no later than five working days after it identified that it was failing to meet that requirement[904].

In principle, in case of an actual breach of binding capital requirements, more urgent action is likely to be needed. However, within the proportionality assessment it should be considered whether the breach can be expected to last only for a limited period of time. Depending on the specific facts and circumstances of the case, the ECB should ask the bank to provide a capital restoration plan (or possibly other supervisory or early intervention measures on top of any measures already applied by the bank under the recovery plan) to address the situation of non-compliance within a certain time period, ideally not going beyond a short timeframe – such as six months –, but with possible extension depending on the circumstances to be concretely assessed (e.g. the market reaction to the plan). This approach can apply also in case of a capital shortfall arising from an asset quality review exercise ascertaining concrete or soon-to-materialise losses in an analytical way in case such shortfall has been adopted in a supervisory decision imposing a specific requirement on the institution (e.g. SREP

[901] See Chapter 3, Paragraph II.
[902] See Chapter 3, Paragraph III.
[903] See Chapter 3, Paragraph 4.1.
[904] As much as in the case of a breach of CRR capital requirements, each breach of Pillar 1 liquidity requirements (as defined in in Articles 412 and 413 CRR) or Pillar 2 liquidity requirements (as defined in Article 105 CRD IV) can provide a basis for considering FOLTF. A breach would consist in not meeting the LCR or, following the entry into force of the CRR II, the NSFR. However, it should be considered that liquidity resources under the LCR are intended to be usable and – with a view to proportionality – it should be considered whether the breach can be expected to last only for a limited period of time. In case of an actual breach of binding liquidity requirements, in principle the supervisor should ask the bank to provide a funding plan to address the issue within a certain period of time (ideally not going beyond a short timeframe, but with some flexibility to adjust the time horizon depending on the circumstances to be concretely assessed, e.g. the banks' survival period, its counter-balancing capacity, signs of possible or actual runs to deposits etc.).

decision) and the institution is non-compliant. For justifying the FOLTF assessment, it is decisive that the prognosis is based on a sound factual basis taking into account the information available[905].

The FOLTF determination can also be based on likely breaches of capital requirements (both Pillar 1 and 2) in the near future. For the purpose of making an assessment of such likely breaches in the near future, objective elements supporting such assessment are necessary (such as a non-renewal of guarantees on a loan portfolio, an anticipation of large losses on the basis of onsite inspection findings or other events, or the inability to cover capital needs arising from a baseline stress test scenario). This means that the ECB's positive assessment that a likely breach of capital requirements will occur in the near future will be a prognosis from today's perspective based on objective elements in consideration of the overall circumstances of the case.

In this case, as in the case of actual breach of capital requirements, the ECB should ask the bank to submit a capital plan for restoring its capital position. If the bank is unable to provide a credible capital plan or the capital plan is not implemented within the requested timeframe, the supervisor has to consider on a comprehensive view of the factual situation whether the institution is FOLTF. Even if the credit institution has delivered a capital plan, the supervisor may conclude on the basis of a comprehensive assessment of the facts that the institution is likely to fail with regard to capital requirement, e.g. if the ECB assesses that the capital plan is unrealistic and not likely to be implemented. However, any such prognosis by the ECB concluding a likely breach of capital requirements must be based on a thorough assessment of the factual basis and ECB must have undertaken effort to get the relevant information[906].

[905] Sources of information for the purpose of determining an institution FOLTF based on its capital position can be seen in the results of asset quality reviews or any valuations conducted in accordance with the BRRD, where available.

[906] The FOLTF determination can also be based on likely breaches of liquidity requirements (both Pillar 1 and 2) in the near future. For the purpose of making an assessment of such likely breach in the near future, objective elements supporting such assessment are necessary (e.g. a non-renewal of liabilities, events having a severe impact on the bank's funding structure and ability to obtain liquidity from the markets or the central bank, etc.). Overall, the ECB's positive assessment that a likely breach of liquidity requirements will occur in the near future will be a prognosis from today's perspective based on relevant objective elements in consideration of all relevant circumstances of the case. In this case, as much as in the case of likely breach of prudential capital requirements, the ECB should ask the bank to submit a funding plan for restoring its liquidity position. If the bank is unable to provide a credible funding plan or the funding plan is not implemented within the requested timeframe, FOLTF can be considered on the basis of the comprehensive assessment of the factual situation. The likely breach of liquidity requirements could be considered also in cases where there is evidence of a bank run building up, with the survival period of banks deteriorating dramatically and falling below a threshold, which can be set on a case-by-case basis by the ECB depending on the overall circumstances and the funding profile of the bank. In cases of bank runs, no sufficient time for a funding plan would be available, and hence the ECB would need to make a judgement based on the known facts at the time.

V. Making Resolution Possible: The MREL capital buffer

5.1. Preliminary considerations

As discussed under Chapter 1, Paragraph III., a second strand of international reforms adopted under the aegis of the FSB in the wake of the GFC concerned the resolution framework for financial institutions. In light of the massive amount of public money that many EU countries had to inject into their banking systems to bail-out credit institutions[907], in 2011 the Financial Stability Board (**FSB**), as mandated by the G-20, published the Key Attributes on effective resolution regimes, which were later endorsed by the G-20 as the '*new international standard for resolution regimes*'[908]. The Key Attributes establish the core elements for an orderly resolution of distressed financial institutions with the aim to preserve the continuity of banks' critical functions while minimising costs for taxpayers. Those standards have been incorporated into EU law through the BRRD, while for EU Member States participating in the Banking Union, this framework is further harmonised by the SRMR[909].

Further developments in this area affect the capacity of G-SIBs to absorb losses and recapitalise in case of resolution. On 9 November 2015, the FSB published the total loss-absorbing capacity (**TLAC**) standard, endorsed a week later by the G-20[910]. External and internal TLAC require G-SIBs to hold a sufficient buffer of liabilities readily available for bail-in within resolution, while leaving full discretion on the side of resolution authorities to decide whether losses should be absorbed through bail-in or the application of other resolution tools that do not necessarily imply write-downs or conversion of capital. Aimed at addressing the 'too-big-to-fail' issue and reducing the impact of systemic banks' failures on public funds, the TLAC standard applies to all G-SIBs (30 worldwide, including 8 banks within the EU) as of January 2019. Being a legally non-binding international soft-law standard, the TLAC requirement has been transposed into the EU legal order by the CRR II[911].

Against this background, the implementation, for first time, in European banking law of common resolution rules uniformly applicable across EU Member States, as derived from the FSB framework, represented a major initiative towards ensuring financial stability and containing the failure of credit institutions at the regional level. To achieve these goals, the effectiveness and credibility of the new EU resolution framework is strongly dependent on the application of a new capital requirement that European banks have to comply with as of 2016, that is the minimum requirement of own funds and eligible liabilities (**MREL**)[912]. As it will be discussed under Paragraph 5.2.2., the MREL also aims at implementing within the EU legal framework the TLAC standard as a Pillar 1 measure applicable to banks with systemic relevance. The rationale for the introduction of the MREL requirement lays in

[907] See Chapter 1, Paragraph 1.5.
[908] See G-20 Leaders' Declaration, Cannes Summit, 3-4 November 2011, Section 13.
[909] See Stamegna (2019).
[910] On the rationale and the stacking order of this capital buffer, see Chapter 1, Paragraph 3.3.
[911] According to Article 92a CRR II, a minimum external TLAC buffer has been mandatorily introduced as Pillar 1 measure for all G-SIBs based in the EU. Starting from January 2022, the minimum required TLAC buffer will need to correspond to 18% of RWAs and, at the same time, 6.75% of the leverage exposure measure. According to Article 92b CRR II, affiliated financial institutions operating in the EU of a third-country G-SIB must comply with the CRR prudential rules by holding at least 90% of the required TLAC.
[912] The obligation of credit institutions to hold a buffer of own funds instruments and liabilities subject to write-down and conversion into equity is of particular importance for the SRB and NRAs in order to apply effectively and in a timely consistent manner the resolution tools and powers set out in the BRRD. For a discussion of the MREL buffer, see, among others, Alvaro et al. (2017); Maragopoulos (2016).

the fact that the BRRD, while establishing a framework aiming to ensure that banks themselves bear the costs of bankruptcy, provides NRAs with the discretion to exempt certain liabilities from absorbing losses in resolution. Such exemption[913] applies, in particular, where:

a) it is not possible to bail-in such liabilities within a reasonable timeframe;
b) the exclusion is strictly necessary and proportionate to achieve the continuity of critical functions and core business lines;
c) the application of the bail-in tool to those liabilities would cause such a destruction in value that losses borne by other creditors would be higher than if those liabilities were not excluded from bail-in; and
d) it is necessary to avoid the spreading of contagion and financial instability, which may cause serious disturbance to the economy of a Member State.

This exemption constitutes an incentive for credit institutions to raise greater proportion of their funding from those liabilities. To guard against this, the BRRD ensures that EU credit institutions shall have enough loss-absorbing capacity so that, in and immediately following a resolution, critical functions can be continued without resorting to taxpayers' funds or financial means of resolution financing arrangements, as well as without putting financial stability at risk. In other words, the MREL ensures that, as much as the TLAC requirement in respect of G-SIBs, EU banks shall have sufficient eligible instruments – in addition to minimum CRR capital – available to make creditors, i.e. debt/equity holders, absorb losses (enabling a 'bail in'), instead of using public funds (conducting a 'bailout'), while the resolution process is underway[914]. The ultimate objective of the MREL is to achieve that, in a resolution scenario, the write-down and conversion of a bank's internal resources will be enough to make up for the losses accrued, as well as to recapitalise the firm (or its successor) until it complies again with mandatory CRR/CRD minimum capital levels. This is done in a manner that respects the hierarchy of claims prescribed in insolvency law, including that equity holder claims are written down before debt holder claims. Unlike a debt-for-equity swap, there is no requirement for consent of shareholders, creditors or management. The end result is to change the capital structure of the resolved credit institution so that what is left is a viable business.

Accordingly, the BRRD MREL framework, as substantially revisited under Directive 2019/879 (the '**BRRD II**')[915], requires banks to meet the MREL buffer at all times, and only subordinated bonds satisfying certain eligibility criteria can be computed towards the MREL ratio[916]. Such buffer of additional subordinated instruments enables NRAs to exercise write-down and conversion powers in an effective and timely consistent manner while compelling private sector involvement (**PSI**), i.e. bearing the losses of an ailing bank[917]. In the view of the FSB and IMF, as well as EU regulators,

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[913] Article 44.3 BRRD.
[914] See EC (2016); Maragopoulos (2016).
[915] Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC.
[916] Article 45b BRRD II.
[917] Article 48 BRRD stipulates the sequence in which the power to write down or convert liabilities should be applied within a resolution procedure. Such order provides that CRR capital instruments should be the first to bear losses, before any other liabilities can be called upon. Article 60 BRRD, instead, lays down a similar provision regarding the power to write down or convert capital instruments when the so-called 'point of non-viability' (**PONV**) is reached (PONV conversion power). More specifically, the BRRD requires capital and debt instruments of an institution entering resolution to be written down or converted in accordance with a loss-absorption waterfall, whose steps are ordered as follows: (1)

compelling investors to bear the losses incurred by the failing credit institution should entail that banks' funding would become sensitive to the risks institutions run and would instil market discipline by putting an end to excessive risk-taking behaviours and overinvestment induced by moral hazard[918].

5.2. Key elements of the MREL

5.2.1. Calibration of the MREL

As discussed, in order to ensure the effectiveness of resolution tools and, when mandated by resolution authorities, conversions and write-downs, the undue structuring and risk-taking by credit institutions must be prevented, so as to limit the risk of contagion or bank runs. To this end, the BRRD calls for banks to issue a robust buffer of subordinated debt, i.e. the MREL capital buffer, to ensure that the resolution plan may be concretely implemented[919]. Each subsidiary identified as resolution entity within the banking group must comply with the MREL at the individual and sub-consolidated level. The MREL buffer has been first introduced by Article 45 BRRD and it has become applicable as of 1 January 2016. However, the MREL framework has been substantially revisited by the BRRD II, which modified inter alia the composition of the denominator of the capital requirement[920].

Whereas the BRRD used total liabilities and own funds (**TLOF**) as reference base (i.e. the denominator of the leverage ratio[921]), under the new framework, the MREL should be expressed as a percentage of RWAs[922] combined with the leverage exposure backstop. The change of the MREL denominator from TLOF to RWAs achieves alignment both with the TLAC standard and the CRR/CRD capital requirements promoting reduced complexity and improved comparability of the capital base of European banks[923].

CET1 items; (2) AT1 instruments; (3) T2 instruments; (4) other forms of subordinated debt that constitute neither Tier 1 nor Tier 2 capital, in accordance with the pecking order of claims in insolvency under the relevant national law; (5) eligible liabilities, in accordance with the pecking order of claims in insolvency under the relevant national law; (6) deposits from natural persons, as well as micro, small and medium-sized enterprises in excess of the amount of covered deposits. As for covered deposits in particular, i.e. those up to an amount of EUR 100,000, the Deposit Guarantee Scheme (**DGS**) will pitch in in their stead. In general, claims within the same rank must be reduced *pari passu* among themselves, and the no-creditor-worse-off (**NCWO**) principle (Article 34.1 (g) BRRD) must apply. Creditors shall not incur losses greater than what would have come to be, had the institution entered normal insolvency proceedings, such that they are also entitled to compensation for the difference.

918 For a critical analysis of the MREL, see Tröger (2017).

919 When a credit institution is declared 'failing or likely to fail' by the ECB or the SRB (see Chapter 3, Paragraph 4.4.) and the publicly administrated resolution procedure applies, banking groups can be resolved according to two different strategies as set out under their resolution plan. Such alternative resolution strategies are defined as the 'single point of entry' strategy (**SPE**) or the 'multiple point of entry' strategy (**MPE**). In the SPE strategy, the holding company of a banking group is put into resolution and losses of operating companies at the subsidiary level are covered by capital and eligible liabilities that are down-streamed from the holding company so that losses are concentrated and crystallised at the top level of the group. Resolution tools, such as bail-in, are applied at the level of the holding company only. On the other hand, in the MPE resolution strategy (which is generally expected to be implemented by complex multinational banking groups operating in different jurisdictions), multiple entities within a banking group are designated as resolution entities and resolution tools are applied at different sub-levels within the group. In this context, the term 'resolution entity' indicates the legal entity within a banking group towards which the BRRD resolution tools are applied by the resolution authority. On the difference between the SPE and MPE resolution strategy, see Stiefmüller (2016); IMF (2012).

920 For a first discussion of the BRRD II, see Maragopoulos (2020); Martino and Parchimowicz (2020).

921 See Chapter 1, Paragraph 2.2.

922 Precisely, Article 45.2 BRRD II defines the denominator of the MREL ratio by cross-referring to the TREA under Article 92.3 CRR, which spells out minimum own funds to be held at all times by banks against RWAs.

923 See EBA (2016), p. 37.

In practice, the different reference base implies only a limited change in the approach used to set the MREL. In accordance with the former framework, resolution authorities set the MREL based on the capital requirements (expressed as a percentage of RWAs) and determined an absolute amount (in EUR) of own funds and eligible liabilities needed. The last step of the determination process included the translation of this amount into a percentage of TLOF, which resolution authorities communicated to banks as the MREL target. This last step will no longer be part of the MREL setting process[924].

5.2.2. Pillar 1 MREL

As mentioned, the former framework applied the same MREL determination approach to all EU banks irrespective of their size or other idiosyncratic characteristics. On the contrary, the BRRD II established a differentiated MREL treatment of banks under which they are classified into two broad categories based on whether they are subject to a fixed Pillar 1 MREL ('**Pillar 1 banks**') or not ('**Pillar 2 banks**'). In this sense, the revised MREL framework aims at creating a level playing field as to capital requirements in order to avoid material variations of MREL targets across banking systems that share similar quantitative characteristics.

In particular, the Pillar 1 banks are divided into the following three categories based on their size, systemic importance and riskiness:

1. resolution entities of G-SIBs, as identified by the FSB and the BCBS[925];
2. top-tier banks, i.e. resolution entities of resolution groups with total assets exceeding EUR 100 billion[926];
3. other Pillar 1 banks, i.e. resolution entities of resolution groups which have been assessed by resolution authorities as likely to pose systemic risk upon failure, though their total assets do not exceed the threshold of EUR 100 billion[927].

For the determination of the so-called 'other Pillar 1 banks', resolution authorities shall take into account i) the prevalence of deposits, and the absence of debt instruments, in the funding model, ii) any limited access to capital markets for eligible liabilities, and iii) the extent to which the resolution entity relies on CET1 capital to meet the MREL.

While all three groups of credit institutions mentioned above are subject to a fixed level of Pillar 1 MREL, the level of subordinated bonds to be held at all times differs among them. Indeed, in line with the TLAC standard, as of 1 January 2022 EU-based G-SIBs must meet a Pillar 1 MREL of at least 18% of RWAs and 6.75% of leverage exposure[928]. From June 2019 to 1 January 2022, a transitional period has been introduced to enable G-SIBs to meet the Pillar 1 MREL in a smooth way. Under the transitional period, G-SIBs shall be allowed to meet a Pillar 1 MREL corresponding to 16% of RWAs and 6% of leverage exposure. Consistently with the TLAC framework, G-SIBs must deduct from their Pillar 1 MREL resources any holdings of MREL-eligible liabilities issued by other

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[924] See Maragopoulos (2020).
[925] Article 92a CRR II for external MREL and Article 92b CRR II for internal MREL.
[926] Article 45c.5 BRRD II.
[927] Article 45c.6 BRRD II.
[928] In the context of the relief measures provided to banks due to the Covid-19 pandemic, Regulation 2020/873 extended the deadline for G-SIBs to meet the leverage ratio buffer by one year to January 2023.

G-SIBs, as the exercise of write-down and conversion powers to MREL instruments issued by G-SIBs could give rise to contagion and threaten financial stability, where these liabilities had been computed by other G-SIBs towards their capital ratios. Such regulatory arrangement mirrors the corresponding deduction approach applied in relation to CRR minimum capital instruments. The extent of deduction is based on the significance of the investment in the other G-SIBs, the duration of the holding and the offsetting of short and long positions[929].

As regards the calibration of Pillar 1 MREL for 'top-tier banks' and 'other Pillar 1 banks', this is linked to the level required by G-SIBs with some adjustments that reflect the distance in terms of assets, riskiness and systemic importance between G-SIBs and these other two categories of banks. Thus, the Pillar 1 MREL applicable to top-tier banks and other Pillar 1 banks is set at the level of 13.5% of RWAs or 5% of leverage exposure[930]. In contrast to G-SIBs, these banks are not required to deduct MREL-eligible liabilities from their own MREL resources. However, the EBA is mandated to assess a possible extension of the deduction requirements also to these banks and an EC's legislative proposal on the appropriate treatment of such holdings may be submitted by mid-2023[931].

5.2.3. Pillar 2 MREL: Calculation and stacking order

The revised resolution framework retains the notion of the bank-specific MREL (Pillar 2 MREL) that applies to all banks, as either an additional requirement (for Pillar 1 banks) or the sole MREL-related requirement (for Pillar 2 banks). Unlike the P2R, which stacks on top of the Pillar 1 capital requirements, the Pillar 2 MREL should not be considered as an add-on to the Pillar 1 MREL. The interaction between the two requirements is as follows: where the fixed Pillar 1 MREL is lower than the bank-specific Pillar 2 MREL (generally this should be considered as the rule), resolution authorities should impose an additional requirement equal to the difference between the two[932].

In this respect, in contrast to CRR minimum capital requirements and the capital conservation buffer, uniformly applicable to all credit institutions, as well as the TLAC standard, uniformly applicable to all G-SIBs[933], the MREL capital ratio, as much as the P2R and the P2G, is a Pillar 2 measure to be determined by NRAs on a case-by-case basis for each credit institution under their

[929] Article 72h CRR II.
[930] Article 45c.5 BRRD II.
[931] Article 504a CRR II.
[932] It is worth mentioning that meeting MREL requirements will challenging for medium-sized credit institutions, as they are typically financed by capital and deposits and have little experience of tapping capital markets. At the same time, these institutions represent a sizeable proportion of the European banking sector. Additionally, given that a number of them are considered significant, they are subject to direct supervision by the ECB and fall within the jurisdiction of the SRB. As a consequence, it has been argued that MREL requirements may constitute a binding constraint on the sustainability of the business model of a large set of European banks. In these terms, see Restoy (2018), p. 8. On the profitability challenges of the European banking sector, see Chapter 4, Paragraph 1.3.
[933] While both the TLAC and the MREL capital standards are founded on the same principles and 'have the same DNA', as both are designed to achieve the objective of maintaining critical economic functions in the event of failure without recourse to public funds, there are some key differences between the two standards. First, the TLAC sets a global standard for G-SIBs, while MREL is for all EU banks (and investment firms). Second, the TLAC describes a Pillar 1 minimum requirement, while MREL is set by NRAs on a bank-by-bank basis starting from the resolution plan. Third, the TLAC requirement is set in terms of RWAs and leverage exposure while MREL is formally set in relation to TLOF or total assets. Fourth, the FSB consultation specifies the quantum and quality of TLAC a G-SIB requires and sets out how TLAC should be distributed within groups. In contrast, the BRRD provides for more flexibility, certainly on whether liabilities need to be subordinated to count as MREL. See Alvaro et al. (2017), p. 24.

remit. Within the Banking Union, this task is conferred to the SRB with respect to SIs[934]. To complete the MREL regime, Article 45.2 BRRD mandated the EBA to further specify in a RTS the assessment criteria to be used by the NRAs to set MREL targets[935].

As mentioned, the MREL ratio is calculated over an institution's TREA, combined with the leverage exposure backstop. With regard to the numerator, the MREL is calculated as the sum of the following two components[936]:

a) *the loss absorption amount*, which would be equal to the overall capital requirement following the SREP (i.e. Pillar 1 and Pillar 2) applicable to the individual credit institution[937], unless differently set by the NRA, and
b) *the recapitalisation amount*, which would be the amount of own funds and eligible liabilities pursuant to Article 45c.3 BRRD that, if written down or converted into equity, would allow the credit institution i) to maintain market access (i.e. comply with Pillar 1 and Pillar 2 capital requirements) and the conditions for authorisation after the implementation of the preferred resolution strategy, and ii) to hold any additional amount of own funds necessary to maintain sufficient market confidence after resolution.

The sum of the above-mentioned amounts is downwards or upwards adjusted by the following factors: i) the NCWO adjustment, which implies that if liabilities likely to be excluded from the bail-in, provided that they satisfy certain conditions, total more than 10% of any class of liabilities ranking equally in insolvency, the SRB adjusts the composition and the level of the MREL in order to avoid the breach of NCWO principle in case of resolution, and ii) the MREL downwards adjustment because of the possible contribution of DGS, that is the reduction of the MREL equal to the amount that the relevant DGS is expected to contribute to financing resolution costs[938].

In turn, pursuant to Article 72b CRR II, instruments and eligible liabilities can be included in the recapitalisation amount of the MREL ratio, only if they satisfy, *inter alia*, the following conditions[939]:

1) the instrument is issued and fully paid up,
2) the liability is not owed to, secured by or guaranteed by the institution itself,
3) the purchase of the instrument was not funded directly or indirectly by the institution,
4) the liability has a remaining maturity of at least one year and where a liability confers upon its owner a right to early reimbursement, the maturity date of that liability must be the first date where such a right arises,
5) the liability does not arise from a derivative, and

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934 Articles 7 and 8 SRMR.

935 Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities (the '**MREL CDR**').

936 Article 45c.3 BRRD II.

937 See Chapter 3, Paragraph 3.3.

938 Article 3 MREL RTS. See, also, Maragopoulos (2016).

939 As discussed under Chapter 3, Paragraph 2.1., the CRR II has further aligned the eligibility criteria of CRR AT1 and T2 instruments with the criteria of MREL-eligible subordinated bonds. Therefore, such financial instruments should be required to fulfil – under a substantial approach – the same economic purpose in order to be classified for regulatory purposes.

6) the liability does not arise from a deposit, which benefits from preference in the national insolvency hierarchy in accordance with Article 108 BRRD[940].

The Pillar 2 MREL ratio is set by the SRB on a case-by-case basis taking into account i) certain characteristics of each SI, and ii) the provisions of resolution planning. The first component of the MREL, i.e. the *loss absorption amount*, consists of the capital instruments already issued by each SI in order to comply with the CRR minimum capital requirements and applicable Pillar 2 requirements, unless differently set by the SRB. In particular, the SRB may request from the ECB-SSM a summary of the capital requirements applicable to relevant SI and set a default loss absorption amount, which is the highest of the following requirements:

a) the overall capital requirement following the SREP (i.e. Pillar 1 and Pillar 2) applicable to the individual credit institution;
b) the Basel I floor under Article 500 CRR;
c) the leverage ratio requirement (and related surcharge for G-SIBs)[941].

Alternatively, the SRB may decide to either i) increase this amount, if it considers that the need to absorb losses in resolution is not fully reflected in the default loss absorption amount[942], or this is necessary to reduce or remove an impediment to resolvability or absorb losses on holdings of MREL instruments issued by other group entities, or ii) lower this amount, if it considers that, after taking into account information received from the ECB-SSM related to the SI's business model, funding model and risk profile, additional own funds requirements imposed on the SI in the context of the SREP are assessed not to be relevant to the need to ensure that losses can be absorbed in resolution, or part of the combined buffer requirement is assessed not to be relevant to the need to ensure that losses can be absorbed in resolution[943].

With regard to the *recapitalisation amount*, in case that the SRB concludes based on the resolvability assessment that the liquidation of the SI is not feasible and credible[944], it has to set a

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[940] According to Article 55 BRRD, where a liability is governed by the law of a third-country, the relevant NRA (including the SRB) may require the bank to demonstrate that any decision of the former to write down or convert that liability would be effective under the law of that third country, with regard to, in particular, the terms and conditions of the contract governing the liability and international agreements on the recognition of resolution proceedings. If the relevant NRA is not satisfied that any decision would be effective under the law of that third country, the liability must not be counted towards the MREL.

[941] Article 92.1 (d) CRR II.

[942] The SRB may do so only after taking into account information requested from the ECB-SSM and relating to the institution's business model, funding model and risk profile. In particular, according to Article 4.1 MREL RTS, the SRB shall take into account: i) a summary of the assessment of each of the business model, funding model and overall risk profile of the SI, ii) a summary of the assessment of whether capital and liquidity held by the SI ensure sound coverage of the risks posed by the business model, funding model and overall risk profile of the institution, iii) information on how risks and vulnerabilities arising from the business model, funding model and overall risk profile of the institution identified in the SREP are reflected, directly or indirectly, in the additional own funds requirements in the context of the Pillar 2, and iv) information on other prudential requirements applied to the SI to address risks and vulnerabilities arising from the business model, funding model and overall risk profile of the institution identified in the SREP.

[943] In case the SRB were to increase or lower the loss absorption amount, it shall provide the ECB with a reasoned explanation of the loss absorption amount that has decided to set. See Article 1.6 MREL RTS.

[944] When assessing the credibility of liquidation, the resolution authority explores the likely impact of the liquidation of the institution on the financial system of any Member State or of the Union, with a view to ensuring the continuity of access to critical functions carried out by the institution and achieving the resolution objectives of Article 31 BRRD. For this purpose, the SRB must take account of the functions performed by the institution and assess if liquidation is likely to have a material adverse impact on any of the following: i) financial market functioning and in particular the impact on

recapitalisation amount. The recapitalisation amount aims at ensuring that, while going concern capital is eroded on the way in to resolution, there is sufficient loss absorbency to convert to equity capital to stabilise the firm. Stabilisation for this purpose means having resources available to allow the firm to be re-authorised by all relevant home and host supervisors and to maintain market access[945].

The recapitalisation amount must be the sum of the following components:

i. the amount necessary in order for the credit institution to meet applicable Pillar 1 and Pillar 2 capital requirements, together with the Basel I floor and leverage ratio requirement, to comply with the conditions for authorisation after the resolution, and
ii. any additional amount necessary to maintain sufficient market confidence, if the resolution authority deems it necessary.

Regarding the second component, i.e. the additional amount required by the SRB in order to maintain sufficient market confidence post-resolution, the latter must not exceed the combined buffer requirement[946] applicable to the SI after the implementation of the resolution tools. Specifically, the additional amount required by the SRB may be lower than the combined buffer requirement if the resolution authority considers that a lower amount would be sufficient to sustain market confidence and ensure the continued provision of critical economic functions by the institution and access to funding, without recourse to extraordinary financial support.

For the purpose of determining the additional amount of capital necessary to support market confidence, the following factors must be taken into account: i) the capital position of peer institutions[947], ii) the capital resources in other entities of the banking group, which would credibly and feasibly be available to support market confidence in the institution following resolution, in the case that these entities:

a) were subsidiaries of the banking group subject to a consolidated MREL at the pre-resolution phase, and continue to be after the implementation of the preferred resolution strategy, and
b) are not expected to maintain market confidence and access to funding on an individual basis following implementation of the preferred resolution strategy[948].

In addition, for the purpose of determining the recapitalisation amount, the SRB may decide, after consultation with the ECB and taking into account the SREP assessment, not to apply to the institution

market confidence, ii) financial market infrastructures, iii) other financial institutions, and iv) the real economy and in particular on the availability of critical financial services.

945 With regard to G-SIBs, the assumption lying behind the calibration of TLAC and MREL is that given the size and complexity of their operations and their activities cross-border, it is hard to conceive of a significant restructuring at the point of resolution. Rather the accent is on stabilising the firm via bail-in to restore solvency to buy time for an orderly restructuring and/or a solvent wind-down afterwards. This should be good for the system and, by preserving value, for creditors of the firm. By contrast, a very small bank may need no MREL beyond its current capital requirements. If, at failure, there is no obstacle to putting the firm into insolvency and paying out covered deposits using the relevant DGS, then no MREL is required beyond capital requirements as a going concern. See Alvaro et al. (2017), p. 24.

946 See Chapter 2, Paragraph 2.3.1.

947 Article 2.8 MREL RTS.

948 Article 2.10 MREL RTS.

under resolution fully or partially the additional own funds requirement or buffer requirements applicable to it in the pre-resolution phase[949].

5.3. Permission to reduce the MREL buffer

As discussed in Chapter III[950], prior to the adoption of the CRR II – but the same holds true also following the adoption of the revised Regulation – banks could reduce, redeem or repurchase CET1, AT1 or Tier 2 instruments under a conditional regime based on which prior permission of the supervisory authority was needed. The CRR II adapted this regime to the introduction of the MREL and extended its scope to MREL-eligible liabilities by adopting a redemption approval regime similar to that for capital instruments.

As such, all Eurozone SIs[951], as of 27 June 2019, are required to seek approval from the SRB to call, redeem, repay or repurchase eligible liabilities instruments, including those with residual maturity of less than one year, before they reach their contractual maturity. Similarly to the regime applicable to own funds reductions to be authorised by the ECB-SSM[952], the CRR II introduces two types of permissions for MREL reductions[953]: i) an instrument-by-instrument permissions regime, and ii) a general prior permission regime, where the credit institution can perform early repayments for a predetermined amount set by the SRB and for a specified period not exceeding one year, subject to the fulfilment of certain conditions[954]. The general prior permissions may be renewed[955].

[949] In light of the high complexity of the procedure to be followed for setting MREL targets, and the significant inter-agency cooperation and information sharing, the main problem put forward by legal scholarship, echoing similar concerns scholars voiced against the European bail-in regime, is that MREL specifications are too detailed and discretionary, and thus do not fully alleviate the predicament of investors in bail-in debt. Quite importantly, given the character of typical MREL instruments as non-runnable long- term debt, even if investors are able to correctly gauge the relevant risk of PSI in a bank's failure at the time of purchase, subsequent adjustments of MREL prescriptions by competent or resolution authorities potentially change the risk profile of the pertinent instruments. Therefore, original pricing decisions, and the market discipline that follows from them, may prove inadequate. Depending on the level of MREL set, the loss-participation of an investor *ceteris paribus* changes and so too should the risk-adjusted interest rate charged in reaction. As a result, if adjustments in MREL calibration are not predictable (and interest rates are not floating in perfect correlation to the changes in the instrument's risk profile), the original price of bail-in capital is either too low (if MREL prescriptions are reduced and thus LGD increases) or too high (if MREL prescriptions are raised and thus LGD decreases). Both forms of mispricing are undesirable from a public policy point of view: while underprizing of risk creates moral hazard, overprizing hampers banks' lending capacity as a consequence of overly unfavourable refinancing costs and therefore impairs growth. In these terms, see Tröger (2017).
[950] See Chapter 3, Paragraph II.
[951] When examining the public administrative tasks and powers of the SRB, reference to SIs shall also include non-significant cross-border banking groups that fall under the remit of the SRM, unless expressly stated otherwise.
[952] See Chapter 3, Paragraph 2.3.
[953] Article 78a CRR II.
[954] According to Article 78a CRR II, in order to be granted a general prior permission, a bank shall provide sufficient safeguards to the NRA and the NCA as to its capacity to operate with own funds and eligible liabilities above the amount of the requirements laid down in the CRR and the BRRD/SRMR, provided that the bank meets the following conditions: i) before or at the same time of the MREL buffer reduction, the credit institution replaces the eligible liabilities instruments with own funds or eligible liabilities instruments of equal or higher quality at terms that are sustainable for the income capacity of the credit institution, and ii) the bank has demonstrated to the satisfaction of the NRA that the own funds and eligible liabilities would, following the MREL reduction, exceed the requirements for own funds and eligible liabilities laid down in the CRR and the BRRD/SRMR by a margin that the NRA, in agreement with the NCA, considers necessary.
[955] As clarified by the SRB, the obligation to seek approval applies to G-SIBs and other institutions with MREL decisions higher than the loss absorption amount. For institutions with MREL shortfalls, approvals can be granted only in case of replacement of eligible liabilities instruments by other eligible liabilities instruments or own funds. This is because in order to reduce eligible liabilities instruments without replacing them, institutions would first need to exceed their MREL requirement by a margin. See SRB (Jun 2019).

According to Article 78a (3) CRR II, the EBA has been mandated to develop an RTS specifying the process for prior permissions before the SRB, including the time limits and information requirements. Until such Level 2 legislation will come into application, the SRB has published its temporary approach to the MREL buffer reductions[956].

Resolution authorities have to reject a redemption request if it does not ensure that the bank's capital and MREL-eligible liabilities after the action will exceed capital requirements and MREL by a sufficient margin. Unlike the TLAC standard, which requires an approval only if the redemption would lead to breach of the TLAC requirement, under the CRR II an approval by the resolution authority is needed in any case. The redemption process confers upon resolution authorities extensive powers to assess and approve redemptions for all liabilities, including those that are no longer MREL-eligible due to having a remaining maturity lower than one year. Furthermore, it leaves room for discretion allowing resolution authorities to define themselves what is the 'necessary margin' above capital requirements and MREL that banks must cover with MREL resources[957].

In order to be granted permission to call, redeem, repay or repurchase eligible liabilities instruments, SIs must send an application to the SRB, specifying which type of permission they seek. Once the SRB has processed the institution's application for permission, the SRB will issue a decision to the institution, and monitor how institutions use their prior permissions. The SRB may request any additional information it deems necessary for the approval process. As such administrative authorisation power centralised to the SRB is the first of this kind over the capital of SIs, it is expected to augment the workload of the SRB quite significantly. In particular, SIs shall transmit a complete application to the SRB at least four months in advance of the date where one of the actions listed under Article 78a CRR II is intended to be performed.

The application, signed by a legally authorised representative of the bank, shall be accompanied by the following information:

a) specification of the legal basis for the application;

b) a well-founded explanation of the rationale for performing the redemption of MREL-eligible liabilities;

c) information on MREL planning covering in relation to, at least, the three following years, with particular reference to: i) the level of eligible liabilities before and after the redemption; ii) the impact of the redemption on the applicable MREL requirements.

[956] See SRB (Jun 2019).

[957] As a feature highly debated in academic literature, it has been argued that the discretionary implementation of resolution tools, according to a strategy devised on a case-by-case basis by an empowered resolution authority to achieve *ex post*-efficient outcomes, has inefficient *ex ante* effects following from uncertainty which – *in extremis* – may compromise the statutory bail-in tool as an adequate mechanism for private sector involvement. Indeed, the regulatory framework can remove the impediments to the desirable incentive effect of PSI emanating from a lack of predictability of outcomes, if it compels banks to issue a sufficient minimum of high-quality, easy to bail-in (subordinated) liabilities. If these instruments provide sufficient loss-bearing capacity in resolution, neither the specific exemptions for certain liabilities nor NCWO principle are crucial in determining the likely outcomes from an investor's perspective. However, in order to predict the trigger for PSI, the specific application of the resolution tools in every single resolution case and the uncertain valuation mechanics of the resolved institution under the BRRD framework bring difficulties for *ex-ante* risk assessment despite prescriptions of high-quality bail-in capital under the MREL. For a critical analysis of the MREL, see Tröger (2017).

In case of replacement of MREL-eligible liabilities[958], SIs shall provide: i) information on the residual maturity of the replaced instrument and the maturity of the replacement instrument, ii) the ranking in the creditor hierarchy of the replaced and the replacement instrument, iii) the cost of the replacement instrument, and iv) the impact of replacing eligible liabilities on the sustainability for the income capacity (profitability) of the institution.

In case of redemption of MREL-eligible liabilities[959], SIs shall provide evidence that the partial or full replacement of the eligible liabilities with own funds instruments is necessary to ensure compliance with own funds requirements laid down in CRR and CRD IV for continuing authorisation.

[958] Article 78a(1)(a) CRR II.
[959] Article 78a(1)(c) CRR II.

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LIST OF ABBREVIATIONS – CHAPTER FOUR

AT1	Additional Tier 1
bp	basis point
BCBS	Banking Committee on Banking Supervision
BIS	Bank for Internal Settlements
BRRD	Banking Recovery and Resolution Directive (*2014/59/EU*)
CJEU	Court of Justice of the European Union
CoE	Cost of Equity
CRD IV	Capital Requirements Directive No IV (*2013/36/EU*)
CRD V	Capital Requirements Directive No V (*2019/878/EU*)
CRR I	Capital Requirements Regulation No I (*2013/575/EU*)
CRR II	Capital Requirements Regulation No II (*2019/876/EU*)
EBA	European Banking Authority
EBU	European Banking Union
EC	European Commission
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
EP	European Parliament
EU	European Union
FR	Framework Regulation
FSB	Financial Stability Board
GDP	Gross Domestic Product
GFC	2007-08 Global Financial Crisis
GovC	Governing Council
G-SIBs	Globally Systemically Important Banks
HVCRE	High Volatility Commercial Real Estate
IMF	International Monetary Fund
LADC	Land Acquisition, Development and Construction
LCR	Liquidity Coverage Ratio
MAG	Macroeconomic Assessment Group
MMT	Modigliani-Miller Theorem
MREL	Minimum Requirements for Own Funds and Eligible Liabilities
NCA(s)	National Competent Authority - ies
NPLs	Non-Performing Loans
ONDs	Options and Discretions

P2G	Pillar 2 Guidance
P2R	Pillar 2 Requirement
RoA	Return on Assets
RoE	Return on Equity
RWAs	Risk-Weighted Assets
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process
SRM	Single Resolution Mechanism
SRMR	Single Resolution Mechanism Regulation (*2014/806/EU*)
SSM	Single Supervisory Mechanism
SSMR	Single Supervisory Mechanism Regulation (*2013/1024/EU*)
T2	Tier 2
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union

CHAPTER FOUR

TRYING TO SQUARE THE CIRCLE: IS THERE A TRADE-OFF BETWEEN FINANCIAL STABILITY AND THE PROFITABILITY OF THE BANKING SECTOR?

I. Ten Years After the Crisis: Is the European Banking Sector Safer? Some Empirical Evidence

1.1. Financial stability as outright objective of the Banking Union

The European financial and sovereign debt crisis has fundamentally transformed the banking landscape in the European Union (**EU**). As discussed in Chapter 2, in order to break the dependence between banks and sovereigns, the European legislator has created the Banking Union (**EBU**). European prudential and resolution regimes have not only further harmonised the diverging national rules, but have also laid the basis for a safer and more adequately capitalised European banking sector[960]. The ultimate objective of these legislative measures is the maintenance of financial stability at the regional level. In this sense, financial stability has created a new objective in European legislation that justifies public interference in economic activities. However, despite this enormous importance, the concept of financial stability remains mostly obscure in case-law[961] and academic literature[962]. This is surprising, especially since a better understanding of financial stability not only gives an overview of the Banking Union, but also helps to put national[963] and supranational[964] disputes into perspective.

As a first approximation, under EU law the concept of 'financial stability' is often used synonymously with financial market stability[965]. In fact, financial stability is related to the financial market. It is broader, however, in the sense that financial stability is not only related to market activity, but also concerns access to and orderly exit from the market. In order to develop a concept of financial stability, one can approach the broader concept of stability and contrast financial stability with price stability[966]. The literature suggests that financial stability should be understood as a state in which

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[960] See Chapter 4, Paragraph 1.2.
[961] CJEU, Case C-370/12 (*Pringle*), 27 November 2012, ECLI:EU:C:2012:756, paras. 135 - 146 on the interpretation of Article 125 Treaty on the Functioning of the European Union (**TFEU**) without attempting a definition of financial stability.
[962] There is no commonly shared definition of the term 'financial stability', towards which macroprudential policies would be geared. While some authors define it as the opposite to the concept of 'financial instability' by referring to episodes of 'financial crises' and to the robustness of the financial system to external shocks, or to shocks originating within the financial system, or, again, in relation to the concept of systemic risk and its sources, academic literature suggests that financial stability can be understood, in its core, as a state in which each part of the financial system can perform its tasks without major disruption. On the various definitions of the term 'financial stability', see Bauerschmidt (2020); Constâncio, ed., et al. (2019); CGFS (May 2010), p. 17, and extensive references included therein.
[963] The *Bundesverfassungsgericht* (German Constitutional Court) 30 July 2019 – 2 BvR 1685/14 and 2 BvR 2631/14, ECLI:DE:BVerfG:2019:rs20190730.2bvr168514, refers to financial stability in multiple instances in respect of the objectives of the Banking Union.
[964] General Court, Case T-122/15 (*Landeskreditbank Baden-Württemberg v. ECB*), 16 May 2017, ECLI:EU:T:2017:337; CJEU, Joined Cases C-152/18 P and C-153/18 P (*Crédit Mutuel Arkéa v. European Central Bank*), 2 October 2019, ECLI:EU:C:2019:810, both judgements make reference to financial stability without engaging into further definitions.
[965] See Lo Schiavo (2017).
[966] Stability is a crucial concept in the European Economic Constitution. It combines law and economics and allows what systems theory calls a 'structural coupling' between the legal system and the economic system. The legal system provides

each part of the financial system can perform its tasks without major disruption. Pursuant to this, financial stability requires that the financial system be able to withstand unforeseen events or shocks without major disruption and continue to perform its function for the economy. Moreover, financial stability constitutes a public good as it is non-rivalrous in the sense that the consumption of financial stability by one actor does not subtract it from the same consumption of other actors in the same system and it is non-excludable in the sense that financial stability is a pool source that cannot be taken away from any actor. Compared to price stability, financial stability is much more difficult to measure and cannot be broken down to a single variable, such as the consumer price index. Rather, financial stability has to operate with many more variables and is not pursued by just one EU Institution. The exact contours and its application to the individual policy fields are rather to be negotiated in an open democratic procedure[967]. Since financial systems are interconnected transnationally, the Union legislature in particular has a crucial role in safeguarding financial stability and in establishing, in line with the objective of Article 3.3 of the Treaty on the European Union (**TEU**), a functioning internal market. In this sense, safeguarding financial stability is a matter of collective responsibility. In a world with cross-border capital flows, no jurisdiction can preserve financial stability domestically through its own policies. Preserving financial stability, either at the regional or global level, requires jurisdictions to cooperate in identifying and mitigating risks to the financial system[968]. Therefore, only a closer examination of the most important laws founding the Banking Union will allow to better understand the functions of the principle of financial stability in Union law.

With regard to the CRD package specifically[969], the CRR, which finds its legal basis in Article 114 TFEU[970], prominently points to financial stability. Recital No 14 refers to the influential De Larosière report[971], which recommended the creation of a single rulebook and a European framework for macroprudential supervision aimed at safeguarding the public good of financial stability. The

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a stable legal framework for economic activity, complemented by a stability-oriented monetary policy. See Bauerschmidt (2020). In the EU, monetary policy is guided by the primary objective of price stability, as is clear from Articles 127.1 and 282.2 TFEU. This requires in the abstract that money retain its value over time. More specifically, the Governing Council (**GovC**) has defined price stability as '*a year- on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%*'. Currently, however, the ECB monetary policy is under strategic review as announced by the new ECB President Ms. Lagarde in September 2020. The publication of the results of the strategic review has been delayed until at least mid-2021 due to the Covid-19 pandemic.

967 See Bauerschmidt (2020).

968 See Schoenmaker and Wagner (2011).

969 Regulation (EU) No 575/2013 of 26 June 2013 (the '**CRR**') and Directive 2013/36/EU of 26 June 2013 (the '**CRD IV**'), as amended in 2019 by Regulation (EU) 2019/876 of 20 May 2019 (the '**CRR II**') and Directive (EU) 2019/878 of 20 May 2019 (the '**CRD V**'), respectively.

970 Article 114 TFEU is currently the most important legal basis for the harmonisation of substantive rules of private law (in its broad meaning). It was added by the Single European Act in 1986 as Article 100a EEC in order to enable the EU legislature to complete the internal market using the procedure of qualified majority voting in the Council (the ordinary legislative procedure now applies). Article 114 TFEU confers upon the EU the competence to enact 'measures for the approximation' (known also as 'harmonisation') of national rules regarding the establishment and functioning of the internal market.

971 In the wake of the 2007-08 global financial crisis (**GFC**), the European Commission (**EC**), in November 2008, tasked a High-Level Group of experts to consider how EU financial supervision could be strengthened. The High-Level Group was chaired by Jacques de Larosière, former managing director of the International Monetary Fund (**IMF**) and former governor of the *Banque de France*. In its February 2009 report (the '**de Larosière Report**'), the Group urged EU Institutions to i) establish a EU-level body responsible for macro-prudential oversight of the European financial system, and ii) transform the existing level 3 committees as part of the so-called Lamfalussy process into three EU agencies. See Chapter 2, Paragraph 2.3.

objective of financial stability has a similar competence-opening function for the CRD IV. Based on Article 53.1 TFEU on the harmonization of the taking up and pursuit of self-employed activities as part of the freedom of establishment, the CRD IV also seeks to promote stability of financial markets[972]. In this respect, the Court of Justice of the European Union (**CJEU**) already held in 1997 that financial stability is a legitimate objective of the Union legislature in the context of the predecessor to Article 53.1 TFEU[973]. Thus, financial stability opens up the Union competence for both the CRR as well as the CRD IV. At the same time, the delimitation function of the principle of financial stability can be clearly shown with regard to the CRR-CRD IV provisions that limit bonus payments for bankers[974]. In the summer of 2013, the United Kingdom, which opposed to such provisions of the CRD package, brought an action before the CJEU arguing, *inter alia*, that the Union bonus schemes do not form part of the internal market but belong into social policy. If that were the case, the Union legislature would have acted on the wrong legal basis and the legislation would be invalid in that regard. Although the United Kingdom later withdrew its claim and the General Court was unable to give judgment, the opinion of Advocate General Jääskinen provides important insights on financial stability. First, he notes that bonuses paid to senior managers of banks have a direct impact on the risk of financial institutions. Therefore, not only the stability of the banks but also the stability of the financial markets in the Union could be affected[975]. In addition, the limitation of bonus payments evidently is not aimed at affording senior managers any form of social protection. Rather, the CRD-IV aims to reduce incentives for excessive risk-taking. This not only limits the exposure of each bank to potential risks, but equally pursues the general interest of financial market stability[976]. In light of the above-mentioned provisions, the capital rules of the CRD package, therefore, highlight the fundamental importance of financial stability in the opening and delimitation of Union competences[977].

Similarly, financial stability also has a competency-opening function for the resolution of banks and, therefore, in relation to the establishment of the second pillar of the EBU, i.e. the Single Resolution Mechanism (**SRM**). The Bank Recovery and Resolution Directive (**BRRD**)[978], based on Article 114 TFEU, states in Recital No 3 that the failure of a cross-border bank is likely to affect the stability of the financial markets in the Member States. Therefore, financial stability is an essential condition for the establishment and functioning of the internal market. In addition, Recital No 18 BRRD explains that for banks operating across the Un-ion, the decisions taken should aim to preserve financial stability and minimize economic and social effects. Equally, the SRM Regulation (**SRMR**)[979], based as well on Article 114 TFEU, pursues the objective of financial stability, as set

[972] Recitals No 29, 30, 47, 50 and 51 CRD IV.
[973] With regard to Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, the CJEU held that the act lawfully promotes freedom of establishment and the freedom to provide services, '*while increasing the stability of the banking system and the protection of savers*'. See CJEU, Case C-233/94 (*Germany v. Parliament and Council*), 13 May 1997, ECLI:EU:C:1997:231, para. 13.
[974] Articles 94(1)(g), 94(2) and Articles 162(1) and (3) CRD IV as well as Article 450 (1)(d), (i) and (j) and Article 521(2) CRR.
[975] AG Jääskinen, Case C-507/13 (*United Kingdom v Parliament and Council*), 20 October 2014, ECLI:EU:C:2014:2394, para. 110.
[976] *Ibid.*, para. 113, referring to Recitals No (62) and (65) CRD IV.
[977] In similar terms, see also Lo Schiavo (2017), p. 25.
[978] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014.
[979] Regulation (EU) No 806/2014 of 15 July 2014.

out, for instance, in Recitals No 2, 10 and 12[980]. The same holds true in respect of the first pillar of the EBU, i.e. the Single Supervisory Mechanism (**SSM**). Recital No 5 SSM Regulation (**SSMR**)[981] expressly state that, in order to preserve financial stability in the Union and increase the positive effects of market integration on growth and welfare, integration of supervisory responsibilities should therefore be enhanced. In this sense, it may be argued that financial stability, as outright objective of the Banking Union, serves as a leitmotif for Union legislation to highlight the multiple functions that this principle has in relation to regulatory action and legitimation, especially when the achievement of financial stability proves the ability of the EU to act swiftly and effectively, as well as to delineate the competences of Union bodies and clarify the interpretation of Union law[982].

[980] As noted, the application of the principle of financial stability may also explain in this context the establishment of the Single Resolution Board (**SRB**) as Union agency. See Bauerschmidt (2020).
[981] Council Regulation (EU) No 1024/2013 of 15 October 2013, as complemented by the ECB Regulation (EU) No 468/2014 of 16 April 2014 (the '**Framework Regulation**', or '**FR**').
[982] See Lo Schiavo (2017), p. 31. For an analysis of the role of the principle of financial stability as justification for restriction of fundamental rights, particularly in the context of the SRM and within the BRRD, see Bauerschmidt (2020), p. 177 ff.

1.2. The costs and benefits of capital requirements. A literature review

As discussed in Chapter 1, the Basel Committee on Banking Supervision's (**BCBS**) prudential reforms – and, particularly, Basel III – have been relying on higher capital quality and higher capital ratios as key prudential tool. These reforms have certainly contributed to making banking systems much more capable of withstanding financial stress and public confidence crises[983]. Major financial indicators confirm this. The aggregate core capital ratio of Euro area banks stood at around 18% at end-2019, almost three times than what is was in 2007. Moreover, since 2015, the leverage ratio among SIs has steadily amounted to levels between 4% and 6%[984]. Regulatory liquidity ratios currently stand at solid levels, with an aggregate liquidity coverage ratio (**LCR**) of 141%. European banks are also making progress in fulfilling the minimum requirement for own funds and eligible liabilities (**MREL**). One indicator of this is that the volume of Additional Tier 1 (**AT1**) bonds and Tier 2 (**T2**) instruments issued by euro area banks and held by investors in the euro area increased by two-thirds between 2013 and 2018. Finally, European banks are also making progress in repairing their balance sheets – the aggregate non-performing loan (**NPL**) ratio has more than halved from its 2013 peak of around 8%, to its current level of 3%. The results of the last EU-wide stress test reflect this[985]. According to the EBA, core capital of euro area banks after stress stood on average at 9.9%, up from 8.8% in the same exercise dated 2016. Underlying the results is the strong build-up of capital buffers in recent years resulting in a better condition at the starting point of the exercise (end-2017)[986].

However, since the early debates, there have been concerns about the size of the potential macroeconomic costs of the Basel III reform, particularly in relation to its capital dimension – something that has been defined in the literature as the '*dark side of the Basel capital requirements*'[987]. Under this perspective, the ultimate unanswered question in international banking regulation relates to what margin the stringency of bank capital requirements is to affect banks' business models, lending volumes and, finally, the interest rates charged to borrowers[988]. Such concerns have stemmed from observations that banks would meet the increased capital adequacy requirements either by widening spreads between lending and deposit rates in order to boost net income, or by reducing exposures and loans[989]. Both strategies could result in a credit slowdown,

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983 Statistics show that for a large part of US and EU banks, the loss incurred over the GFC would have absorbed all of their capital if there was no public assistance in various forms. See Atkinson and Blundell-Wignall (2010), p. 16.
984 See Angeloni (2020a), pp. 5-6.
985 See EBA (Nov 2018), p. 17 ff.
986 See de Guindos (2018).
987 This characherisation comes from Gurrea-Martínez and Remolina (2019).
988 For a review of the academic literature quantifying the effects of higher capital requirements on banks' loan rates and banks' funding structures, see, indicatively, BCBS (2019); Glancy and Kurtzman (2018); Andrle et al. (2017). On the public benefits, from an economic perspective, of new financial regulations and their effects against the direct and indirect costs of capital regulation, see Admati et al. (2013), and extensive references included therein.
989 While, clearly, capital banking regulation cannot be seen as the direct and only culprit for any reduction in banks' lending volumes, it is worth mentioning that, in the pre-GFC environment, the loan growth per annum and the assets growth per annum of EU banks stood at 21.1% and 24.1%, respectively, while, following the deteriorating economic effects of the GFC and the necessary implementation of the Basel III reform, the same indicators fell at -4.8% and -7.9%, respectively. Similarly, in the pre-GFC environment, US banks featured an assets growth per annum of 14.6%, while that indicator currently stands at -3.3%. However, interestingly, US banks managed to recover on the loan growth per annum rate, as the latter stood at 10.2% in the pre-GFC environment, while it currently stands at 11.3% (after, however, growing at the rate of around 50% per annum throughout the 1990s). Data are drawn from Detragiache (2018).

with adverse effects on real economic activity[990]. As a third alternative, banks may decide to increase equity funding, which has a higher required return than debt, and this, in turn, could increase bank funding costs and cause borrowing to become more expensive for banks' customers. However, in all of the three cases, the effects could be minimal if, as the Modigliani-Miller Theorem (**MMT**) points out, either cost increases do not pass through to borrowers, or if changes to capital structure have an offsetting effect on required returns[991].

Against this backdrop, a growing body of empirical studies commenced to investigate the direct and indirect costs of higher capital requirements for banks. As a whole, the consensus in the relevant academic literature suggests that an increase in capital requirements has a positive impact on the real economy in the long term by reducing the probability and the impact of a banking crisis, while reductions of the loan supply and deleveraging of exposures are likely to occur in the short term[992]. For instance, Kashyap et al., by using a panel of US publicly-traded banks from 1976 - 2008 to assess how the riskiness of the bank varies with the level of capitalisation, compute that a 10% increase in the capital adequacy requirement would increase the weighted average cost of capital by about 25 basis points (**bp**), or up to 45 bp using rather extreme assumptions. For these reasons, the Authors argued for a gradual phase-in of Basel III rules[993]. Similarly, a recent study co-authored by Glancy and Kurtzman analyses how banks' loan rates responded to a 50% increase in capital requirements for a subcategory of construction lending that is of crucial importance for mature economies, i.e. high volatility commercial real estate (**HVCRE**)[994]. The results of this study estimate that the HVCRE rule increases loan rates by about 40 bp for HVCRE loans, indicating that a 1% increase in required capital ratios raises loan rates by about 9.5 bp[995]. The partial heterogeneity in the results of quantitative studies on higher capital requirements reflects the fact that historically most estimates come from calibrated models of bank funding costs, with disparate assumptions about the strength of MMT offsets. Namely, studies estimating small effects on loan rates like Kashyap et al. assume bank deleveraging significantly reduces the required return on equity, while estimates at the higher end of the range, such as the study by Cournède and Slovik[996], tend to assume that costs of debt and equity are fixed, and thus increasing equity substantially raises costs[997].

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990 Similar concerns might echo in the future when a non-zero combined buffer requirement or countercyclical capital buffer is applied by competent supervisory authorities.

991 In a nutshell, MMT states that, under the assumption of efficient markets and in the absence of taxes, bankruptcy costs, agency costs, and asymmetric information, an increase in the share of equity relative to liabilities lowers the riskiness of the bank. As a result, the cost of equity is lower for the bank, preserving the total cost of liabilities. In other words, the debt-equity ratio of a bank should not affect its market value (principle of irrelevance of the capital structure). See Modigliani and Miller (1958).

992 See, among others, Hernández de Cos (2020); BCBS (2019); Andrle et al. (2017); BCBS (Aug 2010).

993 See Kashyap et al. (2010).

994 Pursuant to Basel IV, HVCRE lending is the financing of commercial real estate that exhibits higher loss rate volatility (i.e. higher asset correlation) compared to other types of corporate specialised lending. HVCRE includes: i) commercial real estate exposures secured by properties of types that are categorised by the national supervisor as sharing higher volatilities in portfolio default rates, ii) loans financing any of the land acquisition, development and construction (**LADC**) phases for properties of those types in such jurisdictions, and iii) loans financing LADC of any other properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain (e.g. the property has not yet been leased to the occupancy rate prevailing in that geographic market for that type of commercial real estate), unless the borrower has substantial equity at risk. See BCBS (Dec 2019).

995 See Glancy and Kurtzman (2018).

996 See Cournède and Slovik (2011).

997 See Glancy and Kurtzman (2018), p. 5.

Furthermore, in the process of designing Basel III, the Macroeconomic Assessment Group (**MAG**)[998] and BCBS itself carried out an assessment on the impact of higher capital standards. Both studies assumed that the bulk of adjustment in capital ratios would go mainly through lending spreads without a change in the required reduced return on equity (**RoE**)[999]. The MAG's study concluded that a 1 percentage point increase in capital ratios over 4 years would raise interest rate spreads by around 15 bp, pushing down lending volume by approximately 1.5%. As a result, real GDP declines by about 0.2% from the baseline path at the trough[1000]. In the same vein, the BCBS estimated that a 1% increase in capital requirements implies higher spreads by 13 bp in the long run, leading to 0.1% decline in the output level compared to the baseline[1001].

With regard to the European Union specifically, empirical studies showed that Basel III rules had a significant impact on the European banking sector. In particular, it has been calculated that, by end-2019, the industry raised about EUR 1.1 trillion of additional Tier 1 capital, EUR 1.3 trillion of short-term liquidity, and about EUR 2.3 trillion of long-term funding. The capital need was equivalent to almost 60% of all European and US Tier 1 capital outstanding, and the liquidity gap equivalent to roughly 50% of all outstanding short-term liquidity. Closing these gaps had a substantial impact on profitability. All other things being equal, it has been argued that Basel III rules, when fully phased-in, would have reduced RoE for the average bank by about 4% in Europe and about 3% in the United States[1002]. Similarly, according to data from the European Banking Authority (**EBA**) calculated across a sample of 133 EU banks, the introduction of the MREL capital buffer has implied an average increase of approximately 15% of total liabilities and own funds (or 37% of risk-weighted assets (**RWAs**) – bearing in mind that CRR capital requirements are computed in the MREL ratio)[1003]. On an aggregate basis, the EBA has estimated the MREL funding needs would equal to EUR 58.2 - 208.1 billion for the entire EU banking sector. Notwithstanding the significant volume of AT1 and T2 bonds

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[998] With a view to assessing the macroeconomic effects of the transition to strengthened capital and liquidity regulations, in February 2010 the BCBS and the Financial Stability Board (**FSB**) set up the MAG, which comprises economic modelling experts of central banks and regulatory agencies from 15 member jurisdictions and numerous international organisations. The MAG's work is intended to complement that of the BCBS's Long-Term Economic Impact Group and close collaboration with the IMF is an essential part of the process.

[999] Among the large set of traditional indicators used by academics and practitioners to assess banks' performance, the most widely used are i) the RoE, ii) the return on assets (**RoA**), and iii) the cost-to-income ratio. In addition, given the importance of the intermediation function for banks, net interest margin may be typically monitored. RoE can be defined as the ratio of total profit (or loss) for the year to total equity. The RoA is the net income for the year divided by total assets, usually the average value over the year. For a discussion on the pros and cons of RoE as primary bank performance measure, see ECB (Sep 2010).

[1000] See MAG (Dec 2010). From a macroeconomic perspective, it is useful to stress in this context that, as GDP is composed of aggregate consumption demand, aggregate investment demand, Government expenditure on goods and services and net export, to ensure the sustained growth of the economy, investment has to be accelerated, which will boost national income in multiplier effect. The banking sector is a medium by which saving of households and corporates can be channelised into productive investment. If commercial banks are not profitable, i.e. they do not earn net interest margins, credit creation is limited, and, as a consequence, GDP is more likely to remain stagnant.

[1001] See BCBS (Aug 2010).

[1002] See Härle et al. (2010).

[1003] See EBA (Dec 2016). In the case of the EU, MREL requirements needed to be particularly stringent as, unlike in other jurisdictions, the BRRD established minimum bail-in requirements (8% of total liabilities) as a condition for the use of external resources (from the Single Resolution Fund) in resolution. As a consequence, the SRB has established preliminary requirements for all SIs that normally lie between 24 and 26% of RWAs – around 10 percentage points below what estimated by the EBA. However, this is significantly above the TLAC requirements that were established at the global level for G-SIBs. See Restoy (2018), p. 8.

to be issued (and related coupons to be paid to investors), worryingly, as of December 2018, 117 EU resolution groups exhibit an MREL shortfall estimated at EUR 178 billion[1004].

Going forward, the EBA has estimated that the impact of the EU-wide regulations implementing Basel IV[1005] within the Union will cause capital to RWAs to increase by 18.5% on average, equivalent to a total capital shortfall of EUR 52 billion for European banks[1006]. Banks will have to manage the additional capital requirements that this incurs – likely either by increasing pricing or by stepping away from certain businesses or products. Similarly, the ECB-SSM has recently stated that the full implementation of the Basel framework as part of the CRR III/CRD VI package will lead to an increase in minimum capital requirements and, as a result, an aggregated capital shortfall across EU banks[1007]. Furthermore, the European Parliament (**EP**) addressed the topic of capital requirements in its annual report on the Banking Union in 2015, where it is warned EU policy-makers that capital requirements '*beyond a certain threshold may in the short term create unintended consequences, limiting banks' lending capacity*' to the real economy and that '*the interdependence between capital requirements and credit supply is not linear*'[1008]. Along the same line, on 23 November 2016, in view of the comprehensive review of the Basel III framework finalised by the BCBS on 7 December 2017 (Basel IV), the EP adopted a resolution where it stressed that upcoming changes should not have led to an overall significant increase in the capital requirements for banks[1009].

In light of the above, it appears immediately clear that the costs and benefits of banking capital regulation should be carefully weighted by supervisors and regulators. While there is strong empirical evidence suggesting that the net macroeconomic benefits of capital requirements are positive over a wide range of capital levels, as the benefits of the Basel capital regime accrue both to society as a whole, in the form of reduced frequency and impact of banking crises[1010], and to banks directly, in the form of lower funding costs and better-quality lending, growing consensus has undoubtedly emerged among academics that part of these new regulations may have adverse effects, especially for lower-risk institutions. This may also contradict the actual objective of prudential reforms, which is the strengthening of financial stability of banking markets. The aforementioned concerns stand still notwithstanding the fact that regulators and supervisors encourage banks, under a 'sound and prudent' risk management approach, to maintain a management capital buffer on top of their Pillar 1 and Pillar 2 capital requirements with a view to preventing any breach of their CET1 capital demand in case of an unexpected negative change in their overall risk profile. While banks with excess capital are supposed to have the capacity to compensate for any potential corporate lending reduction even when maintaining their management buffer, such 'sound and prudent' approach to managing banking risks

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[1004] See EBA (Feb 2020).
[1005] See Chapter 1, Paragraph IV.
[1006] See EBA (Dec 2020).
[1007] See ECB (Oct 2019).
[1008] See EP (Feb 2016).
[1009] See EP (Nov 2016). This position was reiterated in the annual report on the Banking Union in 2016 and in the annual report on the Banking Union in 2017. See EP (Feb 2017); EP (Feb 2018).
[1010] According to the BCBS, historical experience suggests that, in any given country, banking crises occur on average once every 20 to 25 years, i.e. the average annual probability of a crisis is of the order of 4 to 5%. The evidence indicates that banking crises are associated with large losses in output relative to trend and that these costs extend well beyond the year in which the crisis erupts. The cumulative (discounted) output losses range from a minimum of 20% to well in excess of 100% of pre-crisis output, depending primarily on how long-lasting the effects are estimated to be. See BCBS (Aug 2010), p. 3.

should not be simply taken for granted by regulators and supervisors. Additionally, it should be considered that, intuitively, the further away banks are from insolvency, the lower is the marginal benefit of additional capital protection[1011].

From a legal perspective, in light of the recognised costs of banking capital and the negative effects that potentially they may in part have, on the short term, on banks' RWAs and, ultimately, countries' GDP growth, it becomes of crucial importance that every single percentage point of additional capital that is requested by competent supervisory authorities to banks on top of legislative CRR minimum capital requirements[1012] (such as in the case of the Pillar 2 Requirement (**P2R**), the Pillar 2 Guidance (**P2G**)[1013], the combined buffer requirement[1014] or the MREL[1015]) is duly imposed and motivated pursuant to Article 41.2 of the Charter of Fundamental Rights of the European Union (the '**Charter**') and Article 296.2 TFEU. Such a matter becomes even more of a far-reaching and decisive nature due to the idiosyncratic factors that are currently tearing down the profitability of EU banks and making them struggle with weak income-generation capacity[1016], such as unconventional monetary policy (i.e. negative interest rates on deposits) or the digital revolution in banking services (Fintech).

Against this background, appropriate statement of reason means that ECB supervisory decisions imposing additional capital requirements need to be accompanied by a thorough motivation stating both the material facts and legal reasons behind the adoption of the capital supervisory measure. In particular, the motivation has to explain to the relevant SI in a clear and accessible way, based on and underpinned by material and relevant facts, the concrete circumstances that justify the imposition of additional capital layers. The motivation has to spell out the underlying deliberations so clearly that the addressee is able to deduct the reasons underlying the capital supervisory measure from the motivation itself, and the Court of Justice of the European Union (**CJEU**) can base on the motivation its review of the legality of the supervisory decision[1017]. The motivation may not include contradictions which hinder the addressee to understand the real reasons of the decision[1018]. While the degree of details required for a sufficient motivation depends on the specific circumstances of each case, individual administrative decisions generally require a more detailed motivation than legal

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[1011] See BCBS (Aug 2010), p. 3.
[1012] Article 92 CRR. See Chapter 3, Paragraph II.
[1013] See Chapter 3, Paragraph III.
[1014] See Chapter 2, Paragraph 2.3.1.
[1015] See Chapter 3, Paragraph V.
[1016] On the 'profitability malady' of the EU banking sector and its main causes, see next Paragraph.
[1017] CJEU, Case C-521/09 P (*Elf Aquitaine SA v. Commission*), 29 September 2011, ECLI:EU:C:2011:620, para. 147: '*[t]he statement of reasons required under Article 253 EC must be appropriate to the measure at issue and must disclose in a clear and unequivocal fashion the reasoning followed by the institution which adopted that measure in such a way as to enable the persons concerned to ascertain the reasons for it and to enable the competent Court of the European Union to exercise its jurisdiction to review legality (see France v Commission, paragraph 35, and Deutsche Telekom v Commission, paragraph 130)*'.
[1018] General Court, Case T-587/08 (*Fresh Del Monte Produce, Inc. v. Commission*), 14 March 2013, ECLI:EU:T:2013:129, para. 279: '*A contradiction in the statement of the reasons for a decision constitutes a breach of the obligation laid down in Article 253 EC such as to affect the validity of the measure in question if it is established that, as a result of that contradiction, the addressee of the measure is not in a position to ascertain, wholly or in part, the real reasons for the decision and, as a result, the operative part of the decision is, wholly or in part, devoid of any legal justification (Case T-5/93 Tremblay and Others v Commission [1995] ECR II-185, paragraph 42, and Case T-65/96 Kish Glass v Commission [2000] ECR II-1885, paragraph 85)*'.

acts of general application and mere reference to an applicable provision of law or paraphrasing it is not sufficient[1019].

Under Chapter 4, Paragraph 2.2. we will analyse in detail whether ECB micro- and macroprudential supervisory decisions with regard to the imposition of capital requirements fully meet the legality standards enshrined in the CJEU case-law.

1.3. The profitability malady

As discussed in the previous Paragraph, higher capital requirements, while reinforcing financial stability and lowering funding costs in the long term, tend to have the effect, over a shorter-term horizon, to put banks' business models under pressure, incentivise deleveraging and lower lending volumes. Moreover, while these are general corporate finance trends observed by empirical studies under normal market conditions, the deteriorating economic environment and low interest rates policies that followed the GFC heightened concerns that the introduction of the Basel III capital rules could further scale down banks' profitability and unintentionally fortify weak income-generation capacity.

At EU level, the Chair of the ECB-SSM has defined the chronical disappointing business performance of SSM banks as a '*profitability malady*'[1020]. While, clearly, higher capital requirements cannot be seen as the one and only culprit for low profitability, their impact cannot be overlooked. The supervisor's concerns for bank profitability are well motivated. As noticed by some of the top ECB officials[1021], persistently low returns limit a bank's ability to endogenously generate new capital, making it harder to build up buffers against unexpected shocks. Second, unprofitable institutions prove unattractive to investors, making it harder to raise new capital, expand their business and support growth. Finally, non-lucrative lenders lacking a sustainable business model may be tempted to 'gamble for resurrection' by massively mis-allocating funds to poorly-priced, high-risk assets, or, even worse, to switch off internal compliance controls. As a result, competition will be distorted, real growth constrained, and financial bubbles amplified[1022].

As a consequence of post-GFC reforms and the ramping up of capital and loss absorbing instruments, credit institutions became much more resilient on a going concern and capable of restructuring in the event of non-viability. However, when looking at the Union's banking market, the overall performance of EU banks' shares has been disappointing for long. In 2007, euro area banks earned 12% of their equity. By contrast, in 2019 the RoE of SSM banks stood at 5.5%. This follows a steep and arduous recovery path from a record bottom at 1.3% in 2013, when profits were almost entirely wiped out by loan losses[1023]. In terms of banking business models, this data suggests

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[1019] CJEU, Case C-378/00 (*Commission of the European Communities v. European Parliament and Council of the European Union*), 21 January 2003, ECLI:EU:C:2003:42, para. 68.

[1020] See Enria (2019). The weak profitability of many European banks has long been a matter of concern to the ECB and the SSM. Since 2016, in particular, the ECB has engaged in an *ad-hoc* off-site supervisory reviews and examinations involving all SIs in the euro area. Additionally, business model sustainability and performance indicators have been closely monitored and included in the yearly SSM priorities since 2016.

[1021] See de Guindos (2019).

[1022] On SSM bank profitability, See Resti (2019).

[1023] See Mascher and Strauch (2020).

that improved financial safety is not rewarded through higher share prices if it comes with higher costs and dilutes net returns persistently.

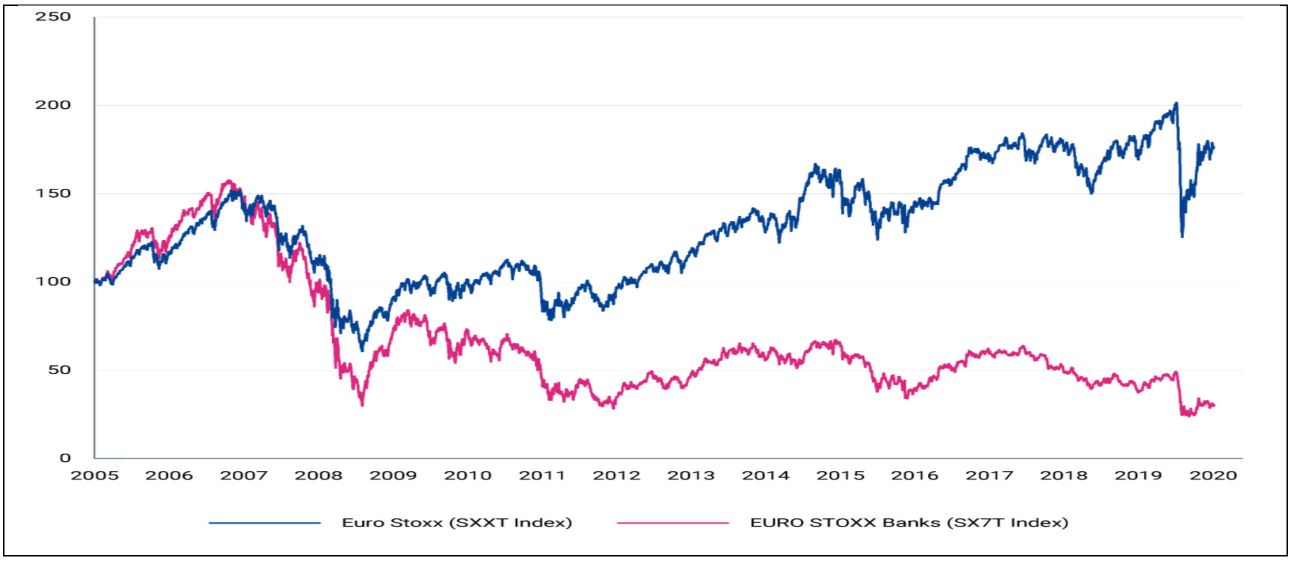

Figure 13. *Performance of EU banks' shares (index performance between August 2005 and August 2020).*
Source: Mascher and Strauch (2020). The indices show net returns. The EURO STOXX Index (SXXT) is a euro area subset of the STOXX Europe 600 Index. With a variable number of components, the index represents large, mid and small capitalisation companies of 11 euro area countries. The SX7T is the net returns version of the SX7E index.

Indeed, EU banking sector's profitability remains overall very low and, relative to peers, profitability of Euro area banks is still lower than that of US banks[1024] or banks from Nordic countries. As clearly showed by Figure 14. below, investors' expectations for many Euro are banks are not satisfied as the cost of equity (**CoE**)[1025] remains higher than the RoE[1026].

[1024] Relative to their EU counterparts, US banks seem to have partly offset the drop in profitability (RoA and RoE) experienced during the GFC. Higher capital levels may have helped achieve a less severe cut in assets, while loans have continued to expand, even in the post-crisis period, helped by a more benign macroeconomic cycle that also lead to lower non-performing loans (**NPLs**). The role of macroeconomic conditions as a driver of the EU-US profitability gap has also been highlighted, together with a surge in US banks' M&A activity which has not been mirrored by European banks. Additionally, the US have adopted a bolder stance towards the 2007-2009 crisis, quickly injecting equity capital and cheap liquidity into the system. This has made it easier for American lenders to quickly dispose of toxic assets and to achieve capital ratios well above those of European institutions. See Resti (2019). A different study by the IMF on the EU-US divide in banking performance compared multiple profitability indicators between EU and US-based G-SIBs, finding that, while prior to the outbreak of the GFC, the RoE and the loan growth per annum were higher for EU banks, in the post-crisis environment EU banks commenced to perform significantly worse compared to their US peers on virtually every indicator: the RoA is set at 0.1% against 0.6%; the RoE is set at 2.4% against 8.4%; the asset growth per annum is set at -7.9% against -3.3%; the loan growth per annum is set at -4.8% against 11.3%; NPLs are set at 4.6% against 1.9%; and the net interest income is set at 1.2% against 1.7%. See Detragiache et al. (2018).
[1025] CoE can be defined as the return that investors require on average for taking an equity stake in banks.
[1026] While the returns generated by euro area banks in the largest countries ranged between 0.5% and 9% at end-2019 – only a minority of these banks exceeded the 8% lower bound of the average CoE. See Mascher and Strauch (2020).

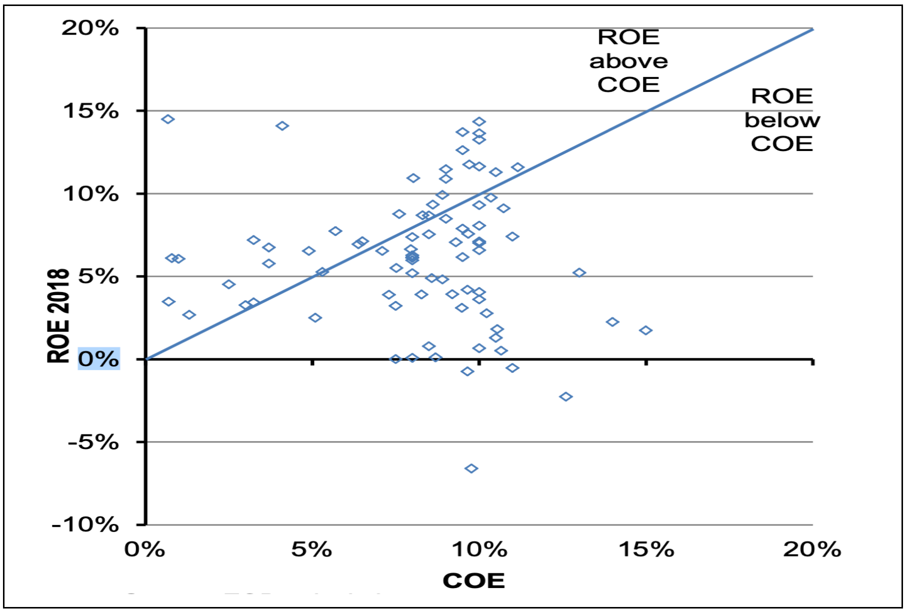

Figure 14. *EU banking sector's profitability (RoE against CoE).*
Source: Enria (2019).

In general terms, it is worth noticing that the ECB itself does not expect the Euro area banking system to return to pre-crisis RoE levels, due to inter alia changes in the environment, risk profile and capitalisation of the Eurozone banking market[1027]. Moreover, following the spectacular losses that occurred during the GFC and the massive government interventions of the last decade, there is little support for banks returning to RoE ratios of well above 20%, as these have proved to be mostly unsustainable[1028]. However, the current environment of low profitability is of particular concern and current policy discussions do not aim at restoring pre-crisis RoE ratios. Rather, the risk EU authorities are currently facing is not to be able to fully ensure financial stability at the regional level and the soundness of European banking intermediaries notwithstanding the pervasive and costly reforms implemented in the last years.

In particular, ECB-SSM's assessments dated 2019 revealed that Eurozone banks' profitability is not expected to recover any time soon due to i) lower impairments, which were the main driver of higher profits in 2018 (and impairments are not expected to decrease much further in the near future), ii) operating profits, trading income and operating income, which generally decreased, and iii) operating costs, which are slightly increasing[1029]. Even more worryingly, with the outbreak of Covid-19, market expectations of European banks' returns have further deteriorated. First, EU banking intermediaries are currently experiencing greater margin compression amid a prolonged negative interest rate environment, as well as uncertain loan growth prospects given the business standstill and expected secular changes in spending behaviour. Second, investments have been undermined by increase in loan losses due to the pandemic economic scarring effects, coupled with uncertain trading revenues hampered by increasing volatility – despite massive central bank interventions. Third, a key factor hindering EU banks' market value growth as further exposed by the pandemic is the largely incomplete transformation of banks' business models, which affects the whole sector horizontally

[1027] See ECB (Sep 2018), p. 11.
[1028] See ECB (Sep 2010).
[1029] See Enria (2019).

and places many banks behind the technological innovation curve. As a result, according to market analysts' projections, earnings per share in August 2020 corresponded to around 15% of what they were in mid-2019. And in 2021, they are expected to improve to only 50% relative to August 2019. It will take more than three years for the average earnings per share of listed euro area banks to approach the already depressed pre-GFC levels[1030].

Due to this long-standing worrying scenario described above, in 2016 the SSM decided to investigate further the issue of weak profitability using a bank-level micro-perspective approach and proposed a thematic review on profitability and business models involving all SIs (the '**review**')[1031]. The review aimed at i) analysing the main drivers behind low profits in the European banking sector, ii) delivering tools to analyse the strengths and weaknesses of business models adopted by banks, and iii) evaluating their capacity to detect and alleviate these weaknesses, and their capacity to monitor how low profitability affects their risk-taking behaviour. The results of the review, published in 2018, highlight three main factors explaining why profits remain low, namely: i) high level of NPLs, ii) macroeconomic conditions, and iii) excessive competition[1032].

More into details, the review showed that Eurozone lenders face a wide range of challenges, including pressure on revenues due to competition and low interest rates, significant write-offs on NPLs, the legacy costs of overly granular branch networks, and the need to adapt to tougher regulations. Bank-by-bank inspections carried out by the ECB as part of this thematic review have also shown that many institutions lack 'strategic steering capabilities', as management cannot set a clear path towards long-term profitability objectives[1033]. Additionally, costs are not effectively allocated to individual business lines and distribution channels; risk-sensitivity, internal reporting and loan pricing schemes also need improving[1034]. At the same time, as the review clearly explains, Eurozone banks are not affected uniformly by these factors. In contrast, the level of profitability and its main drivers differ significantly across institutions and countries. No easily identifiable common factors explaining the superior profitability of some credit institutions were found. Banks that are relatively cost-efficient differ in terms of size, business model and country of origin[1035]. The review

[1030] Data are drawn from Mascher and Strauch (2020).

[1031] The full name of the report is '*The SSM thematic review of profitability and business models – Report on the outcome of the assessment*', see ECB (2018).

[1032] For a rigorous analysis of the ECB thematic review, see also Farina et al. (2020).

[1033] Multiple empirical studies analysing corporate governance practices in banking across the main Eurozone jurisdictions highlighted the importance of sound corporate governance culture for banks' performance. For instance, Hau and Thum (2009) provide evidence of a systematic underperformance of Germany's state-owned banks and relate it to the quality of bank governance, documenting that the magnitude of bank losses in the financial crisis are associated with board incompetence in finance. Cuñat and Garicano (2009) show that the Spanish *Cajas* whose chief executives had no prior banking experience and no graduate education – but did have strong political connection – extended more loans to real estate developers and fared substantially worse both before and during the crisis. The close connection between politicians and bank managers was also a factor in Spanish supervisors' regulatory forbearance during the crisis, and the banks' forbearance on bad loans to developers (Garicano (2012)). Similarly, the debacle of *Monte dei Paschi di Siena* in Italy – whose main shareholder is a foundation largely controlled by local politicians – originates from the botched acquisition of Banca *Antonveneta* in 2007, performed by a politically connected bank chief. These studies are referred to by ESRB (2014), p. 40.

[1034] See Resti (2019).

[1035] In particular, the ECB states that, in spite of a challenging business environment, 22 SIs from 12 countries have consistently outperformed their peers over the last three years. These 22 SIs achieved an average RoE of 6-15% over the last three years; weighted by total assets, this sample even achieved an average RoE above 8% over the same time period. Similarly, they overall reached an RoA which was 20-25 basis points higher than the SSM average. See ECB (Sep 2018), p. 10.

concludes that for some banks '*this was due to being very cost-efficient, while others managed to generate significantly higher revenues (relative to their total assets) than their peers. These banks are diverse in terms of size, business model and country of origin. This emphasizes that each bank needs to find its optimal trade-off and that it is feasible to be profitable even in challenging macroeconomic conditions regardless of a bank's business model*'[1036].

Against this backdrop, in the view of the ECB[1037], the remedy to weak income-generation does not lie either in slowing down the cleaning up of banks' balance sheets or in watering down key regulatory reforms – such as Basel III capital standards – as this would just make EU banks weaker before the next recession. To restore profitability, the ECB concluded that SSM banks should instead concentrate their efforts on cost efficiency, the refocusing of their business models and digitalisation. On the other hand, from a regulatory perspective, the Chair of the SSM has recently mentioned[1038] at least five areas where European and national authorities should focus their efforts on removing structural impediments with a view to boosting Euro area banks' profitability and creating a genuinely pan-European banking market:

- the harmonisation of national administrative liquidation frameworks, which should facilitate the smooth exit from the market by weak institutions[1039];
- the completion of the Banking Union with the entry into force of its third pillar, i.e. a European deposit insurance scheme (**EDIS**), which would lessen the need for ring-fencing[1040];
- guarantees and commitments for intragroup support should be incorporated into recovery and resolution plans, thereby creating room for more group-wide management of capital and liquidity within the EBU;
- identify and remove regulatory obstacles to cross-border banking M&A transactions[1041];

[1036] See ECB (Sep 2018), p. 10.
[1037] See Enria (2019).
[1038] *Ibid.*
[1039] This point has also been repeatedly made by the Chair of the SRB, Ms. König. See, most recently, König (2019).
[1040] The full operationalization of the EBU would enable European banks to reap the full benefits of a single market by addressing remaining concerns about the free movement of capital and liquidity within banking groups, and help to strengthen the euro area economy at large. With regard to the third pillar, i.e. the EDIS, national deposit insurance schemers are currently regulated by Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (the '**DGS Directive**'). The DGS Directive does not provide for a fully unified framework for the structure and functioning of deposit insurance schemes and left EU Member States considerable discretion. In general, the national deposit insurance funds are funded and managed differently. Among other differences, in several countries the legal number of days for payout from the national deposit guarantee fund still exceeds seven days (although this is still in line with the transition period envisaged under the DGS Directive). Most importantly, however, the concern for national deposit insurance schemes is that they may be seen as vulnerable to the weaknesses of their national banking systems and sovereigns in a crisis, and eventually perceived as providing an insufficient level of insurance. Depositors who view their savings at risk could withdraw deposits and, in extreme cases, trigger bank runs, as it occurred during the GFC. If a system is at risk of failing, political pressure will build for the sovereign itself to step in and provide assurances that would intensify a sovereign-bank doom loop. Against this backdrop, the EDIS would create trust among savers that they can count on a deposit insurance which is able to cover even extreme failures in a country's banking system. This, in turn, would strengthen financial stability across the entire Union. With a full operational EDIS, moreover, supervisory and resolution responsibility would better match financial liability: deposit insurance would be performed at the same level as supervision and resolution, dissipating fears of unequal treatment. Increasing European responsibilities also reduces the possible impact of bank failures on sovereigns and weakens the 'doom loop'. For a discussion of the EDIS and the completion of the Banking Union, see Fioretti et al. (2019).
[1041] These will be discussed in detail under Chapter 4, Paragraph 2.1.

- complete the efforts to establish a liquid and efficient market for securitisation, with standard contractual features[1042].

Some of these regulatory issues in the current EU banking architecture will be discussed further under Chapter 4, Paragraph II. In the same Chapter, we will also provide specific policy suggestions with a view to ensuring effective judicial protection of credit institutions with respect to the imposition of additional capital measures by European public authorities.

[1042] This has been partly achieved by Regulation (EU) 2017/2401 of the European Parliament and of 12 December 2017 amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (the '**Regulation 2401**'). Regulation 2401 lays down the substantive elements of an overarching EU securitisation framework, with criteria to identify simple, transparent and standardised securitisations and a system of supervision to monitor the correct application of those criteria by originators, sponsors, issuers and institutional investors. Furthermore, Regulation 2401 provides for a set of common requirements on risk retention, due diligence and disclosure for all financial services sectors.

II. An Assessment of the Post-Crisis European Capital Adequacy Framework

2.1. The European Banking Union: What are the missing pieces?

In general terms, banks play a key role as savings intermediaries and providers of financial services in every society. This holds particularly true for European countries. In comparison to the United States, where capital markets are much more significant in volumes of transactions, the size of the Euro area banking sector roughly amounts to 280% of the Eurozone gross domestic product (**GDP**), while in the US the same ratio stands at 91%. Additionally, estimates on banking concentration point out that in the Euro area there are 44 banks' branches every 100,000 inhabitants, in the US 26. In contrast, around 78% of the US banking sector is publicly traded, while such figure in the Euro area remains low at 52%[1043]. In this context, the Banking Union project launched in 2012 by EU authorities can be considered a reform comparable in importance to the customs union (1957), the competition framework (from the 1960s onwards), the single market (1990s) and the euro (1999)[1044].

The EBU had two purposes. The first was to make banks sound and resilient, preventing new devastating upheavals like the euro area sovereign debt crisis. The second, complementary aim was to build a truly European banking sector, including few pan-continental banks capable of competing on a global scale. If we look back at what has been done, a paradox becomes apparent. The EBU was largely successful on the first purpose. In the main, banks are now more solid and stable than they were in the pre-GFC environment – they have more capital and of better quality, balance sheets have been largely cleaned-up from dubious assets, Pillar 3 transparency and corporate governance have improved. Where the Banking Union has not yet delivered the expected results, instead, is in building a European banking sector[1045]. When the EBU was established, scholars predicted that, in particular, two positive effects would have materialised. Firstly, cross-border banking groups should have functioned better, as they would have been able to optimise their internal management of capital and liquidity and reduce compliance costs. In this respect, unified supervision under the SSM would have also created greater trust among European banks. Secondly, consolidation would have been much more likely to occur in the European banking sector. Indeed, weak profitability and excess capacity of European banking markets suggested that efficiency gains would have derived from more consolidation within the now harmonised prudential framework of the Banking Union[1046].

However, eight years on, banks in the Euro area are as national as they were, if not more. Troubled lenders have sought survival by shedding foreign operations. Moreover, cross-border merger and acquisition activity among EBU banks is very low and has not significantly increased since 2014[1047]. In principle, by establishing a single supervisory jurisdiction in all euro area countries, common resolution rules, a mutualised contingency fund and a single administrative authority to deal with the failure of SIs, the Banking Union should have helped eliminate institutional barriers for the cross-

[1043] See Restoy (2018), p. 5.
[1044] In these terms, see Angeloni (2020a).
[1045] See Angeloni (2020b).
[1046] See Ferrarini (2015), p. 57.
[1047] In fact, the number of M&As transactions between European banks has been steadily decreasing since the early 2000s. Data show that in 2000 the number of banking M&As transactions in the Euro area was roughly 90, while it decreased to around 60 in 2007, and then it reached its lowest peak from 2014 onwards with around 20 M&As transactions per year. See Enria (2019).

border integration of the banking industry. Yet available evidence shows that, at least so far, the creation of the SSM and the SRM have not had any marked impact on the structure of the European banking industry. For example, the share of cross-border loans to and deposits from non-banks in the euro zone remains low – around 8% and 6%, respectively – and has slightly decreased over the last few years. In the same vein, the share of domestically owned banks in the national banking systems remains high, at 83%, roughly the same level as in 2014, before the establishment of the SSM[1048]. As clearly spelled out by Chair of the SSM, therefore, more is needed to foster the integration of the industry. Indeed, a number of commentators and policy-makers have pointed to several obstacles that have not been removed by the European co-legislators and that may obstruct further integration in European banking systems. As mentioned in the previous Paragraph, most of the obstacles identified have a regulatory character[1049].

First, to a certain extent banking markets remain fragmented along national lines, as EU Member States are still ring-fencing intra-group liquidity and capital, preventing cross-border banks from reaping the efficiency benefits of the EBU. Indeed, while Basel standards are traditionally implemented in the EU on all levels of prudential consolidation (i.e. individual, sub-consolidated and consolidated levels), the CRR acknowledges that, under specific circumstances, applying own funds and liquidity requirements at the individual level within banking groups may not be necessary, allowing for case-by-case exemptions (i.e. capital and liquidity waivers)[1050]. Capital waivers are, however, made available only for individual group entities that are located in the same Member State as their parent company and, therefore, are not accessible on a cross-border basis. In the case of liquidity, provided that all the competent authorities involved agree that a set of conditions are verified, several group entities authorised in different Member States can be supervised as a single liquidity subgroup (within the broader group)[1051]. Additionally, with the aim of limiting interconnectedness within groups and the extent to which group entities can be exposed to each other, the large exposure regime is also generally applied to intra-group exposures, unless *ad hoc* exemptions are granted[1052]. In this respect, recent estimates by the ECB show that the value of high-quality liquid assets held by non-domestic subsidiaries of globally systemically important banks (**G-**

[1048] See Restoy (2018), p. 3.
[1049] In the same vein, see also Angeloni (2020b). The Author notes that the obstacles to the creation of a truly pan-European banking sector are mostly of regulatory nature. While the ECB as single supervisor was created, the barriers which make cross-border activities unattractive are still there. For instance, banks acquiring foreign subsidiaries or creating new ones face heavy macroprudential requirements, because cross-border participations are still treated as foreign even though they are under the same supervisory and regulatory umbrella. Additionally, the CRR forbids intra-group cross-border capital movements. National ring-fencing hampers efficient liquidity management. Lastly, credit ratings contribute to the hurdle, penalising subsidiaries if the parent company is located in a country with a lower sovereign rating.
[1050] See Article 7 and 8 CRR, respectively.
[1051] Requiring a banking group to place capital and liquidity resources under local supervision may affect the efficiency of the group-wide management of resources and have an impact on the group's cost of capital or funding. Furthermore, local requirements may also constrain the capability of the group to support one or more group entities in the event of idiosyncratic shocks through the redirection of capital or liquidity resources from more solid group entities. The intra-group implementation of the large exposures regime may also, to some extent, prevent the redeployment of large amounts of resources across entities of the same group. To the extent that they affect the efficiency and hence the costs of carrying out banking business via multiple subsidiaries, these regulatory factors may discourage consolidation strategies, on both a domestic and a cross-border basis. See Gardella et al. (2020).
[1052] See Articles 429.7, 429 (a) and 429 (b) CRR.

SIBs) in the Euro area in order to comply with the 100% liquidity coverage ratio (**LCR**) requirement[1053] amounted to approximately EUR 130 billion over the period Q3 2016 - Q4 2017[1054].

Second, excess capacity in the European banking market has not been eliminated since the GFC and consolidation is not taking off. Compared with the United States, only a small number of banks exited the market in the Euro area[1055]. At the same time, M&A transactions have not recovered since the crisis, especially cross-border M&As. With a view to boosting Eurozone banking M&As, in January 2021 the ECB has published its '*Guide on the supervisory approach to consolidation in the banking sector*' (the '**ECB Guide on consolidation**'), in which it intended to clarify, within the current regulatory framework, the principles underpinning the prudential supervisory approach the ECB will follow when requested to approve mergers between two supervised entities. Under this perspective, the ECB Guide on consolidation aims at enhancing market transparency and helping stakeholders to understand the ECB-SSM supervisory expectations geared at safeguarding the safety and soundness of credit institutions resulting from complex business combinations[1056].

Third, national administrative liquidation frameworks should be harmonised, with a view to facilitating the smooth exit from the market by weak credit institutions. The 'normal' insolvency frameworks that apply to banks vary considerably across EU Member States. In some Member States, there is a specific insolvency regime for banks, distinct from the ordinary corporate regime, while in others banks are subject to the general insolvency framework, with or without modifications. Frameworks also vary as to whether they are judicial or administrative. Within those different formats, national insolvency regimes also differ in key substantive respects. These include the grounds for insolvency[1057]; the procedures and tools that are available, as it clearly emerged from the first 'resolution cases' following the establishment of the SRM[1058]; and sources of external funding that may be available.

[1053] See Chapter 1, Paragraph 2.3.

[1054] See ECB (May 2018).

[1055] In the time period from 2008 to 2012, it has been calculated that around 500 banks exited the US banking market. In comparison, during the same reference period, less than 200 credit institutions exited the market at the Euro area level. See Enria (2019).

[1056] In particular, the ECB Guide on consolidation shall enhance the transparency and predictability of supervisory actions and help credit institutions design prudentially sustainable projects by spelling out: i) the ECB-SSM overall approach to the supervisory assessment of consolidation projects, ii) the supervisory expectations regarding consolidation projects, iii) the supervisory approach to key prudential aspects of the consolidation transaction, iv) the ongoing supervision of the newly combined entity, and v) the cases of application of this framework to consolidation transactions involving LSIs. See ECB (Jan 2021).

[1057] In some EU Member States, banks are subject to the general corporate insolvency regime. Grounds for insolvency in such cases are typically based on balance sheet or cash flow insolvency: for example, when the liabilities exceed the assets or the entity is unable to pay its debts as they fall due. Such grounds are not aligned with the conditions for resolution ('failing or likely to fail') under the BRRD (see Chapter 3, Paragraph 4.4.). This could theoretically result in a situation in which a bank is declared to be failing by the relevant resolution authority but insolvency cannot be initiated, and the failing bank remains in limbo. In countries with modified or bank-specific insolvency regimes, other grounds may be available such as those based on quantitative capital thresholds or on other material regulatory breaches. However, it is rare that insolvency regimes include forward-looking grounds, such as the 'likely to fail' condition for resolution in respect of capital and liquidity requirements. As a consequence, insolvency is often initiated at a stage when the franchise value has already been largely eroded, making it considerably more difficult to preserve viable business and maximise whatever value remains. See Restoy et al. (2020). For a comparative analysis of the national insolvency triggers for banks in Italy, Luxembourg, Germany and Spain specifically, see Yoo (2018), p. 146.

[1058] A clear example of the regulatory differences among EU Member States as a matter of insolvency procedures and tools relates to two recent cases concerning the liquidation of two Italian banks, i.e. *Banca Popolare di Vicenza S.p.A.* and *Veneto Banca S.p.A.* (the '**Veneto banks**'), and the Luxembourgish credit institution *ABLV Bank Luxembourg S.A.*

Fourth, options and discretions (**ONDs**) available under Union law should be phased out from the single rulebook as soon as possible[1059]. Since the establishment of the EBU and the setting up of the SSM, the case for maintaining those ONDs conferred by primary EU law upon the National Competent Authorities (**NCAs**) seems unjustified in the Euro area, given the presence of a single supervisor[1060]. Some ONDs are permanent, while others are temporary, to allow for a gradual implementation of the new rules. Some ONDs address the level of capital requirements[1061], while others refer to the quality of capital[1062]. Recent research shows that '*banks established in EU countries with less stringent prudential regulation (for either regulatory flexibility or supervisory discretion) were more likely to require public support during the global financial crisis*', suggesting that differences in the national implementation of regulatory standards could lead to excessive risk-taking by banks and result in negative spillovers on public finances[1063]. Furthermore, the fragmented application of the ONDs regime can impair the comparability of the key indicators of banking stability, in particular of capital ratios, because the quantity and quality of capital can differ across

('**ABLV Luxembourg**'). In June 2017, the ECB determined that the Veneto banks were failing or likely to fail as the two banks repeatedly breached supervisory capital requirements. On the same day, the SRB determined that resolution action with respect to these banks was not necessary in the public interest in accordance with Article 18.1 (c) and Article 18.5 SRMR. The SRB considered, in particular, that the failure of these banks was not likely to result in significant adverse effects on financial stability, and that normal Italian insolvency proceedings would achieve the resolution objectives to the same extent as resolution. As a consequence, the SRB concluded that the winding up of the Veneto banks had to take place under Italian insolvency proceedings. In the second case, which occurred in 2018, the ECB determined that ABLV Luxembourg was failing or likely to fail as the bank was likely unable to pay its debts or other liabilities as they fall due. On the same day, the SRB decided that that resolution action was not necessary in the public interest. The SRB assessed that the functions performed by ABLV Luxembourg were not critical and the failure of the bank was not likely to result in significant adverse effects on financial stability in Luxembourg or in other Member States. As a consequence, the SRB concluded that the winding up of the bank had to take place under the law of Luxembourg. On 9 March 2018, however, the Luxembourg District Court rejected the request to put ABLV Luxembourg into national winding-up proceedings and instead imposed a suspension of payments in accordance with the applicable national framework. Evidently, although the situation of the Veneto banks and ABLV Luxembourg were comparable in that all the three banks were determined as failing or likely to fail while resolution action was deemed not necessary in the public interest in accordance with the EU resolution framework, the outcomes of these two cases were substantially different. The Veneto banks were liquidated in accordance with the applicable national insolvency law, while in Luxembourg the competent national court rejected the initiation of winding-up proceedings in respect of ABLV Luxembourg and instead imposed a suspension of payments, which prohibits payments by the bank and is only temporary in nature by virtue of law. The complexity of 21 different insolvency frameworks, coupled with uncertainties as regards their interpretation and application by either practitioners and the judiciary, clearly represents a big factor of impediment to Eurozone banking M&As. For an analysis of the first 'resolution cases' from a prudential perspective, see Yoo (2018), pp. 140-141.

[1059] In an apparently incoherent fashion in respect of the goal to establish a fully harmonised European single rulebook for banking services, the CRD V package augmented the number of ONDs previously set out under the CRD IV package. The CRR II and the CRD V embed altogether around 200 ONDs, out of which around 150 ONDs are of microprudential nature and whose exercise is demanded to NCAs. For an analysis of the taxonomy of ONDs according to the SSMR and the ECB exercise of ONDs available in Union law, see Bassani (2019), p. 135 ff.

[1060] For this reason, the ECB-SSM harmonised the ONDs within its remit and adopted two separate legal acts, an ECB Regulation (binding) and an ECB Guide (non-binding) in March 2016. In its capacity as single supervisor, the ECB's ultimate goal was to remove ONDs' fragmentation effects to ensure all SIs are treated the same under its direct jurisdiction. This is a remarkable step forward for the banks under the ECB's direct jurisdiction. Currently, the ECB-SSM framework on applicable ONDs is under review to align it with the entry into force of the CRD V package. In respect of the whole EU regulatory space, however, fragmentation effects of the different applications of ONDs are still in place in respect of non-Banking Union EU Member States. With respect of the ECB Regulation on ONDs, see Regulation (EU) 2016/445 of the European Central Bank of 14 March 2016 on the exercise of options and discretions available in Union law (ECB/2016/4). In respect of the ECB Guide on ONDs, see ECB (Nov 2016).

[1061] See, for instance, Articles 26.3 (a), 26.3 (b) and 78.1 (b) CRR.

[1062] See, for instance, Articles 49 and 471.1 CRR.

[1063] See Maddaloni and Scopelliti (2019).

Member States, making it difficult to gauge the real capital strength of the banks, thus undermining the transparency in the outcome of supervisory actions[1064].

In line with several other policy commentators, we believe that, in the context of the upcoming CRR III/CRD VI review, part of the afore-mentioned regulatory obstacles could be addressed aiming at creating a cross-border banking sector truly European.

2.2. Selected issues of judicial protection

In the previous Paragraph we analysed certain legislative obstacles in EU banking regulation which may hamper cross-border operations of European banks and constrict their profitability drivers, and proposed regulatory solutions to address such obstacles. In this Paragraph 2.2., we will focus on selected issues stemming from the EU capital adequacy framework which, in our view, hinder full judicial protection of the addressees of ECB administrative decisions relating to the quality and composition of banking capital. As discussed, in light of the recognised costs of banking capital as quantified by a growing body of academic papers[1065], and the potentially negative effects that it may in part have, on the short term, on lending volumes, changes in banks' regulatory RWAs and, ultimately, countries' GDP growth, it is of crucial importance that every single percentage point of additional capital that is requested by competent EBU public authorities to banks and added on top of CRR minimum capital requirements[1066] is duly motivated pursuant to Article 41.2 of the Charter of Fundamental Rights of the European Union (the '**Charter**') and Article 296.2 TFEU, as interpreted by the relevant CJEU case-law.

First, it may be argued that the P2R framework introduced by the CRD IV and implemented by the ECB in the first five SREP cycles was likely to be in breach of due process requirements[1067]. This holds true, in particular, in respect of the duty of motivation of administrative legal acts as enshrined under the Charter and interpreted by the CJEU. Such issue has been examined by legal scholars[1068], and also publicly noted by the EBA[1069] and the EP[1070]. In particular, as discussed under Chapter 4, Paragraph 1.2., supervised entities have a right to receive a statement of reasons when they are the addressees of ECB supervisory decisions[1071]. It is important to note that the duty of the ECB to give reasons knows no exceptions. The ECB statement of reasons shall '*contain the material facts and legal reasons on which the ECB supervisory decision is based*'[1072]. According to settled case-law of European courts, the function of the duty to give reasons is to enable the persons concerned to ascertain the reasons for the adopted measures and to enable the competent Union court to exercise its power of review. Additionally, the motivation of the supervisory decision has to explain to the

[1064] See Gardella et al. (2020).
[1065] See Chapter 4, Paragraph 1.2.
[1066] Article 92 CRR. See Chapter 3, Paragraph II.
[1067] Article 22 SSMR and Articles 25 ff. FR.
[1068] See Pitz and Schuster (2016).
[1069] See EBA (Jul 2016).
[1070] See EP (Feb 2016).
[1071] This follows from Article 41.2 Charter, Article 296 TFEU and further provisions under Article 22.2 SSMR and Article 33 FR.
[1072] Article 33 FR.

relevant SI in a clear and accessible way, based on and underpinned by material and relevant facts, the concrete circumstances that justify the imposition of additional capital layers[1073].

Against this background, as a rule SREP supervisory decisions are not publicly available. However, according to empirical studies[1074], ECB's SREP supervisory decisions imposing additional own funds as P2R (or, even if non-binding, P2G) reveal a certain degree of '*standardisation of wording*', even if adopted on a case-by-case basis. Additionally, while the ECB identifies concrete prudential deficiencies of banks on an individual basis, it does not provide much detail on the detected issues[1075]. Taking into consideration the results of this study, a number of legal issues arise. It may be argued that, first, ECB's SREP decisions do not provide an adequate level of transparency and disclosure[1076]. Indeed, considering that the ECB's statement of reasons is rather short and do not provide any detail on the identified deficiencies, such a supervisory approach makes it difficult – if not impossible – to adequately address concrete supervisory weaknesses, and link these to the amount of the SREP capital add-on. Importantly, according to this paper, the ECB does not communicate to supervised entities how the SREP capital add-on is allocated to specific core SREP elements[1077] or identified weaknesses. It may be argued, therefore, that the process of calculating the amount of the SREP capital add-on is not sufficiently transparent and the fundamental right of the duty of motivation, as interpreted by the CJEU under a substance over form approach, is not sufficiently upheld by the ECB[1078]. This legal issue is particularly relevant due to the fact that, as published by

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[1073] CJEU, Case C-521/09 P (*Elf Aquitaine SA v. Commission*), 29 September 2011, ECLI:EU:C:2011:620, para. 147: '*[t]he statement of reasons required under Article 253 EC must be appropriate to the measure at issue and must disclose in a clear and unequivocal fashion the reasoning followed by the institution which adopted that measure in such a way as to enable the persons concerned to ascertain the reasons for it and to enable the competent Court of the European Union to exercise its jurisdiction to review legality (see France v Commission, paragraph 35, and Deutsche Telekom v Commission, paragraph 130)*'.

[1074] See Pitz and Schuster (2016). As clarified by the Authors in their study, a number of SREP decisions have been confidentially made available to them by a selected number of banks directly supervised by the ECB.

[1075] For instance, one bank was criticised for '*not taking into account the IRRBB adequately*'. With regard to another bank, the ECB complained that '*the IT infrastructure and process landscape, including outsourcing arrangements was complex and that this could lead to potential operational problems and risks.*'. The ECB pointed out to other banks that they '*incurred significant concentration risk regarding key customers and intra-group exposures towards a group of connected clients.*'. Other aspects that the ECB regarded critically in its 2015 SREP were '*high foreign exchange risks and high NPL ratios.*'. One bank was criticised for '*not fully ensuring the sound management and coverage of risks by arrangements, strategies, processes and mechanism*' and institution for their '*inappropriate quality of internal governance and deficiencies in the arrangements, processes and mechanisms with regard to the internal limits on inter-bank lending*'. See Pitz and Schuster (2016), p. 348.

[1076] On the importance of transparency and disclosure in order to ensure the acceptance of the SREP, see Schoenmaker and Véron, eds., (2016).

[1077] See Chapter 3, Paragraph 3.3.

[1078] The lack of transparency on the side of the ECB leads to another issue with regard to due process requirements in the context of the SREP. As mentioned in Chapter 2, banks also have the procedural right to be heard. According to Article 31.1 FR, the party must be given the opportunity of commenting on the '*facts, objections and legal grounds relevant to the ECB supervisory decisions.*'. The duty to inform the institutions of the material facts, objections and legal grounds of the SREP decision is relevant also for another reason. Pursuant to the SSMR, the ECB may base its decision only on objections on which the parties concerned have been able to comment (Article 22.1 SSMR). Article 33.3 FR extends this to facts. Prior to the adoption of the SREP decision, the ECB meets with the institution and discusses certain prudential aspects relating to its governance and risk management processes. The ECB provides a formal draft SREP decision, and also a presentation that includes a preliminary outcome of the SREP. After receiving the draft decision, supervised entities are granted a two weeks period during which they can send written submissions to the ECB. From a purely formal perspective, the ECB grants the right to be heard in an adequate manner. However, one may question whether the right to be heard is fully effective and particularly valuable to the institutions, considering the lack of detail with regard to the P2R in the ECB's supervisory decisions, since it is difficult to comment and, eventually, challenge a decision on findings that are not described with sufficient detail.

the ECB on 30 January 2020[1079], P2R requirements for individual SSM banks are usually comprised in a range up to 3.50% of additional Tier 1 capital. If one is to add on top of this the P2G (to be fully covered with CET1 instruments), ECB-SSM Pillar 2 requirements may be, in a substantial number of cases across the Banking Union, well above 5% of Tier 1 capital to RWAs, which is almost the same level of minimum Tier 1 capital imposed on banks by lawmakers under Article 92 CRR.

One could take the view that these issues are excusable since the SSM is still in its initial phase and that the ECB should be granted further time in order to develop a benchmark for the substantive and procedural requirements of the SREP process. However, in our view, the fact that the SREP process is still at a relatively early stage cannot deprive banks of their fundamental procedural rights granted through the TFEU and the FR. In this sense, also the EBA, while examining the ECB-SSM's supervisory practices in the context of the SREP, noted that '*in a number of cases, the additional capital requirements were set in a holistic way without decomposing the capital requirements on the basis of the underlying risk drivers*'[1080]. Additionally, the EP as well called for more transparency of the Pillar 2 supervisory capital requirements. In particular, in the 2015 Banking Union report, it stated the following: '[The EP] *considers transparency vis-à-vis market players and the public, including on sensitive topics such as capital targets as a result of the SREP cycle, supervisory practices and other requirements, to be essential for a level playing field between supervised entities, for fair competition in the banking market and for avoiding situations where regulatory uncertainty negatively influences banks' business strategy; underlines that transparency of both supervisors and supervised entities is also a prerequisite for accountability, as it allows Parliament and the public to be informed about key policy issues and to assess consistency with rules and supervisory practices; calls for more transparency with regard to pillar 2 decisions and justifications*'[1081].

To react to this, in our view, significant breach of the EU fundamental rights framework and ensure full judicial protection on the side of Eurozone supervised entities, the CRD V introduced Article 104a with the aim at clarifying the conditions for setting additional own funds requirements, emphasising their 'tailored', risk-based nature[1082]. To this end, the new Article 104a CRD V stresses the link between supervisory assessment and the internal capital adequacy assessment process (**ICAAP**), as it intends to reinforce the link between risk drivers and supervisory measures – and additional own funds in particular – in line with the EBA Guidelines on common procedures and

[1079] According to the new Article 438 (b) CRR II, SSM banks are required to annually disclose the P2R imposed on them by the ECB-SSM, i.e. '*the amount of the additional own funds requirements based on the supervisory review process [...} and its composition in terms of Common Equity Tier 1, additional Tier 1 and Tier 2 instruments*'. While such provision will apply, as the majority of CRR II rules, as of 21 June 2021, the ECB managed to achieve voluntary disclosure of the P2R also for the 2020 SREP cycle, asking all SIs to approve the publication by the ECB of such figures – which will, in any case, become a binding exercise as of the 2021 SREP cycle onwards. On whether the SREP exercise (and resolution planning outcomes) may be qualified as '*inside information*' under the EU market abuse legislation, see Alibrandi and Malvagna (2020).
[1080] See EBA (Jul 2016).
[1081] See EP (Feb 2016).
[1082] In particular, Article 104a (5) CRD V reads: '*The competent authority shall duly justify in writing to each institution the decision to impose an additional own funds requirement under point (a) of Article 104(1), at least by giving a clear account of the full assessment of the elements referred to in paragraphs 1 to 4 of this Article. That justification shall include, in the case set out in point (e) of paragraph 1 of this Article, a specific statement of the reasons for which the imposition of guidance on additional own funds is no longer considered sufficient*'.

methodologies for the supervisory review and evaluation process (the '**SREP Guidelines**')[1083]. To what extent, and how quickly, the ECB will be able to incorporate such CRD V provision in its SREP cycle and internal supervisory processes remains to be seen, also considering that the obligation to state reasons on the side of the ECB existed in full also before the entry into force of the CRD V.

Undesirably, however, the CRD V did not take the stance to extend such express obligation of motivation also to the P2G. This is even more concerning as the P2G, in contrast to the P2R, is – formally, at least – a non-legally binding requirement. Hence, in this case the obligation to state reasons by the ECB might be circumvented more easily. However, no one doubts that banks – and economic actors more in general – tend to consider 'supervisory or regulatory expectations' issued by European public administrative bodies as having a degree of compulsoriness extremely close, if not identical, to the one of formally binding requirements[1084]. This holds particularly in the EU financial environment, where the use of multitude soft-law, formally non-binding, legal instruments by EU authorities is widespread. In light of the above, we would consider appropriate, in the upcoming CRD VI package review, to expressly include the same transparency and accountability obligation to state reasons by the ECB-SSM also with regard to the imposition of a certain amount of CET1 own funds as P2G.

Second, a significant breach of banks' full judicial protection is determined, in our view, with reference to the imposition of macroprudential capital buffers by the ECB on Eurozone banks[1085]. In this regard, the FR stipulates that proceedings pursuant to Article 5 SSMR shall neither constitute ECB supervisory decisions[1086] nor NCA supervisory procedures[1087], without prejudice to Article 22 SSMR in relation to decisions addressed to individual supervised entities[1088]. The provision embedded in Article 101.2 FR, according to which procedures under Article 5 SSMR are not ECB supervisory procedures, clearly intends to avoid the application of the procedural provisions of the FR[1089]. In light of Article 41 Charter, Article 296 TFEU and Article 22 SSMR, we would argue that this is not compatible with the EU legal framework[1090]. Rather, the FR should be amended to ensure that the procedural safeguards enshrined under the SSM framework apply if macroprudential instruments adopted by the ECB, as it may well be the case, relate to a wider group of specific credit institutions, or, even, in such a case where macroprudential measures are to be applied to all Eurozone banks indistinctively.

Third, a particular issue of judicial protection relates, in our view, to the procedure that leads to the imposition of the additional capital surcharge to G-SIBs, as determined by the FSB and the BCBS, in close cooperation with national authorities[1091]. Within the Banking Union, the G-SIB buffer is normally implemented by NCAs at domestic level – and, therefore, not by the ECB-SSM – through

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[1083] EBA, *Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing - Consolidated version*, EBA/GL/2014/13, 19 July 2018.
[1084] Among the many cases, a clear example of such a functioning of EU financial and prudential law are the SSM supervisory expectations for prudential provisioning in respect of NPLs included by the ECB in its, formally non-binding, '*Guidance to banks on non-performing loans*'. See ECB (Mar 2017).
[1085] See Chapter 2, Paragraph 2.3.1.
[1086] Article 2 No (24) FR.
[1087] Article 2 No (25) FR.
[1088] Article 101.2 FR.
[1089] Articles 25 ff. FR.
[1090] In the same terms, see also Lackhoff (2017), p. 190.
[1091] See Chapter 1, Paragraph 3.1.

an extension of the capital conservation buffer, or through a dedicated G-SIB buffer. Implementation by NCAs is done according to a regulatory framework fully harmonised, at EU level, by the EBA[1092]. In this context, it is worth mentioning that the EBA methodology for identifying G-SIBs closely follows the approach of the BCBS to identifying G-SIBs. Indeed, as put forward by the EBA[1093], the list of EU G-SIBs identified by the BCBS/FSB and the banks identified as G-SIBs by EU and national authorities have been identical since 2014, and are expected to remain so in the future.

Against this background, it seems evident that, even if under a formal perspective the G-SIB buffer is imposed, within the EU, by each NCA according to the EBA methodology, the decision on the substance of the subject matter, i.e. the allocation of G-SIBs to one of the five buckets corresponding to higher CET1 buffers in the range from 1% to 3.5%, is ultimately taken by the FSB and the BCBS, in close cooperation with the relevant national authorities. Suffice it to recall here that the G-SIB list itself is published by the FSB (and not by NCAs nor the ECB), and that the underlying methodology for the identification of G-SIBs is laid out by the BCBS in a document approved by the Board of Directors of the Bank for Internal Settlements (**BIS**). Out of 30 G-SIBs identified globally, eight are established within the EU[1094]. In case a EU bank was added to the FSB G-SIB list for the first time, resulting in new CET1 capital requirements to be met at all times[1095], or one of the eight already identified EU G-SIBs was moved to a higher bucket from one year to the next one, resulting in higher CET1 capital requirements to be met at all times, challenging the NCA supervisory decision before national courts would be a sub-optimal solution in terms of judicial protection, due to the fact that it shall prove extremely challenging for each EU G-SIB to demonstrate in a domestic legal proceeding any administrative substantial or procedural flaw on the side of the NCA in the adoption of that supervisory measure. Indeed, national courts would not be in the position to fully assess the rationale for the imposition of a higher CET1 buffer on a given G-SIB, as the NCAs, while taking part in the discussions at the international level to impose the contested G-SIB buffer, would in substance cross-refer in their decisions to the FSB list and the FSB/BCBS determination to include that G-SIB in a specific capital bucket rather than in a different one. Additionally, challenging the imposition of a G-SIB buffer at domestic level may create harmful precedents where domestic courts, embedded into profoundly different constitutional and political systems, take a substantive stance on the FSB/BCBS

[1092] As discussed in Chapter 1, Paragraph 3.1., in July 2018 the BCBS published an update to its approach to identifying G-SIBs. This second version replaced the July 2013 BCBS methodology that had for the first time established an international framework for identifying G-SIBs. In response to that, the CRD V mandated the EBA to update the indicators of the RTS on the EU methodology for identifying G-SIBs, as currently set out under Commission Delegated Regulation (EU) No 1222/2014 of 8 October 2014. On 4 November 2020, the EBA published the revised version of its RTS and Guidelines that will be submitted to the EC for endorsement. In particular, the EBA updated the methodology for the identification of G-SIBs to exclude the cross-border activities of EU banks in Member States participating to the Banking Union, with the aim of recognising the efforts made in recent years to create harmonised European banking regulation and a common approach to resolution. Within the same document, the EBA also updated its soft law guidance on G-SIBs disclosure, which apply, in addition to banks that have already been identified as G-SIBs, to other large EU financial institutions that have an overall leverage ratio exposure measure exceeding EUR 200 billion. The key objective of the EBA's disclosure revisions is to enable EU national authorities to perform the identification and scoring process and disclosure in a timely manner, and in particular before the identification of any financial institution as G-SIB. See EBA (2020).

[1093] See EBA (2020), p. 3.

[1094] These are *BNP Paribas*, *Deutsche Bank*, *Groupe BPCE*, *Groupe Crédit Agricole*, *ING Bank*, *Santander Société Générale* and *Unicredit*.

[1095] For instance, this was the case of *Groupe BPCE* in 2018.

bucket allocation and – directly or indirectly – interpret in an incoherent and not uniform fashion the BCBS assessment criteria for the identification of G-SIBs.

In light of the above, to avoid possible disruptions to the FSB/BCBS G-SIB capital framework and ensure, on the one hand, its coherent interpretation and application worldwide, as well as, on the other, a more effective judicial protection mechanism for G-SIBs, we would call for the establishment of an independent Administrative Tribunal, internal to the BIS, to serve as fora of last resort for the adjudication of regulatory disputes arising from the allocation of banks to a certain capital bucket in the FSB list. While the decisions of this independent Administrative Tribunal would not be of a binding nature (as the FSB and the BCBS are not Treaty-based organisations), and, therefore, the supervisory decision adopted by the NCA imposing the G-SIB capital surcharge would still need to be challenged before national courts, we believe that such decisions, of a arbitral, or quasi-judicial, nature, would set significant precedents that will be taken into due consideration by national courts and, to a large extent, would contribute to the coherent interpretation of the FSB/BCBS G-SIB capital framework and offer G-SIBs an authoritative forum where to challenge before an independent panel composed by selected experts the FSB/BCBS decision to impose on them higher capital requirements.

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Conclusions

The present work aims at assessing the 'revolution' that occurred in international banking capital regulation over the last decade. Following the outbreak of the 2007-08 global financial crisis, concern of systemic risk ultimately forced many national governments to take unprecedented action to inject liquidity, provide capital support and give guarantees to domestic and international financial institutions considered as systemically important or 'too big to fail', thereby exposing taxpayers to losses associated with the aggressive, highly-leveraged investment decisions made by these financial institutions. The regulatory reform action on capital markets, public finances and banking services carried forward by global standard-setters in the last ten years under the aegis of the G-20, and its technocratic administrative arm, i.e. the Financial Stability Board, as supported by the International Monetary Fund, has been striking for breadth and depth. The risk-taking behaviours of nation states and private economic actors alike have been radically transformed by a multitude of highly technical rules, whose overall effects are – still – not entirely known to any international organisation or policy-maker.

At this point in time, following the economic fallout of the worst recession that hit human societies in the 20th century (pending a full assessment of the unpredictable effects of the Covid-19 pandemic), the international community is 'learning by doing'. In the meantime, G-20 countries have sought to implement the whole banking reform at the national level and have hailed the structural changes of banks' capital and liquidity as a great achievement. The expansion of the regulatory boundaries pursued by the Basel III reform and the Financial Stability Board's resolution standards has been regarded, in fact, as a decisive step toward establishing a well-functioning, level playing field for international banks, which can now complete at the global level, having internalised the costs of their risk-taking (mis)behaviours. Currently, regulators and supervisors find themselves in between these two phases of the policy cycle. Between a phase where strong regulation and supervision are encouraged, as the memories of the recent crisis are still recent, and one phase where there are strong calls for fewer restrictions and capital regulation loosening. Regulation, regardless of its soft law or hard law nature, should strike a balance between efficiency and stability so that it would do little to harm the domestic (of countries that adopt them) or global economic growth. The most desirable goal is to create a resilient financial system without hampering financial inclusion and economic growth.

With regard to banking regulation specifically, the ultimate unanswered question in the international policy debate relates to what margin the stringency of the bank capital requirements introduced by the Basel Committee on Banking Supervision affect banks' lending volumes and the interest rates charged to the clients and borrowers of credit institutions. Such concerns have stemmed from a possibility that banks would meet the increased capital adequacy requirements introduced at the global level either by widening spreads between lending and deposit rates in order to boost net income, or by reducing exposures and loans. Both strategies could result in a credit slowdown, with adverse effects on real economic activity. In addition to the Basel III capital reform, also the Financial Stability introduced further capital layers of convertible subordinated liabilities that European banks are currently struggling to comply with. From a legal perspective, in light of the recognised costs of banking capital, and the potentially negative effects that it may in part have, on the short term, on lending volumes, changes in banks' regulatory exposures and, ultimately, the growth of economies, it is of crucial importance that every single percentage point of additional capital that is requested by competent supervisory authorities to banks ensures that all substantial and procedural requirements set out under the European framework of fundamental rights and the Treaties are met.

Within the Banking Union, such concerns essentially apply to the European Central Bank as central authority of the Single Supervisory Mechanism, which is called to impose on Euro area banks a wide range of micro- and macroprudential capital buffers. In this respect, even if the overall benefits of the Single Supervisory Mechanism are paramount, and it is not even imaginable only after six years of operations to renationalise banking supervision within the Euro area, we discussed under Chapter Four that there is significant margin of improvement for the European Central Bank in this specific segment of prudential supervision, particularly in relation to the imposition of Pillar 2 capital requirements. On the other hand, Chapter Four put forward some policy suggestions to improve the EU capital adequacy framework from a regulatory standpoint. These policy suggestions concern four different aspects of the European banking regulations, that is the application of capital and liquidity waivers on a cross-border basis, the creation of supervisory incentives in respect of banking M&A transactions, the harmonisation of national bank liquidation regimes, and the phasing out of options and discretions from the single rulebook. The objective of such proposals is to eliminate the cross-border barriers to the operation of Eurozone banks with a view to re-boosting their profitability drivers and help them cure the 'profitability malady' that since a decade has affected them, as it has been defined by the Chair of the Single Supervisory Mechanism. In addition, it would be to of crucial importance to complete as a matter of priority the project of the Banking Union and its third pillar, to avoid that, as occurred following the 2007-08 global financial crisis, national banking and capital markets of EU Member States start increasingly separating along national lines. Reversing this trend is capital for the durability of the European Union itself, as if banking and capital cross-border claims become so small that they are no longer systemically important – as was the case before the introduction of the euro – the risk that financial integration brought about by the euro would be largely unwound would become concrete and possibly irreversible, at least for quite a long time. While on the short term there may even be benefits in the re-nationationalisation of banking systems (bank crises would have less of a systemic impact; countries current accounts' would become less dependent from cross-border lending and capital inflows), the ultimate objective of EU authorities should be to have deep enough financial integration to ensure that capital flows freely throughout the currency area.

Against this backdrop, this work provides an overview of the Banking Union capital adequacy framework and unites several strands of the literature. It analyses the transfer to the supranational level of multiple administrative powers previously exercised by the competent supervisory authorities of EU Member States. Such public powers relate, *inter alia*, to approvals to compute financial instruments for regulatory purposes, to reduce own funds, and to use specific internal risk measurement approaches to calculate capital requirements to cover for credit risk, market risk and operational risk. Additionally, it also discusses the Pillar 2 process implemented by the European Central Bank to assess the overall risks faced by the significant credit institutions it is mandated to supervise, and the recently introduced power of the Single Resolution Board to reduce buffers of eligible debt.

In conclusion, while the prudential supervisory law segment of the European legal order is highly technical and may be largely perceived as intellectually arid, it undoubtedly is of decisive importance for our economies and, ultimately, society at large. Banking regulation affects the lives of many much more than what may be immediately perceived at first glance. Hopefully, the present study may enrich the academic debate on this topic and stimulate further research and discussions among academics, policy-makers as well as the public at large.